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EDITED TRANSCRIPT OF PROCEEDINGS OF THE BUSINESS ROUNDTABLE / EMORY UNIVERSITY LAW AND ECONOMICS CENTER CONFERENCE ON REMEDIES UNDER THE ALI PROPOSALS: LAW AND ECONOMICS

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Edited by Larry E. Ribstein

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The following is a transcript of remarks made at the Business Roundtable/Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals held at the Marriott Hotel in New Orleans, Louisiana, on May 2-5, 1985. The transcript has been heavily edited stylistically and organizationally to present these remarks in a more readable form.

The participants in the symposium were:

Professor Armen A. Alchian, University of California, Los Angeles, Department of Economics
Professor Michael Bradley, University of Michigan Graduate School of Business
Professor William J. Carney, Emory University School of Law
Professor Harold Demsetz, University of California, Los Angeles, Department of Economics
Professor Michael P. Dooley, University of Virginia School of Law
Professor Daniel R. Fischel, University of Chicago School of Law
Professor Charles J. Goetz, University of Virginia School of Law
Professor John A.C. Hetherington, University of Virginia School of Law
Professor Richard W. Leftwich, University of Chicago Graduate School of Business
Professor John Leubsdorf, Rutgers University, Newark, School of Law (Visiting)
Professor Jonathan R. Macey, Emory University School of Law
Professor Henry G. Manne, Emory University Law and Economics Center
Professor James S. Mofsky, University of Miami School of Law
Professor B. Peter Pashigian, University of Chicago Graduate School of Business
Professor Larry E. Ribstein, Washington University School of Law (Visiting)

Professor Donald E. Schwartz, Georgetown University Law Center
Professor Kenneth E. Scott, Stanford University Law School
Professor Gordon Tullock, George Mason University Center for the Study of Public Choice
Professor Elliot J. Weiss, Yeshiva University School of Law
Professor Nicholas Wolfson, University of Connecticut School of Law

I
THE ECONOMIC RATIONALE FOR RULES LIMITING DIRECTORS' LIABILITY

FISCHEL: Our paper attempts to analyze various doctrines in corporate law in light of some of the criticisms of those doctrines that have been made for a long time. Most of the doctrines, as well as the criticisms, relate to various restrictions on the ability of shareholders to sue directors.

Directors are not liable for negligence. Many other people in contractual or tort relationships can be sued for negligent-like behavior. Frequently, highly self-interested action is also not subject to suit. For example, it is hard to think of a more self-interested decision than the amount of compensation you pay yourself, which all corporate statutes give directors the power to decide. Historically, to the best of my knowledge in the context of publicly-held corporations, there have been no more than a trivial number of successful suits against directors of publicly-held corporations challenging the amount of compensation that they have decided to pay themselves.

In addition to the substantive limitations on the ability of shareholders to sue, there are also procedural limitations, many of which deal with the derivative suit. Of special importance lately has been the role of so-called special litigation committees. Special litigation committees are appointed by directors who have been named as defendants in suits. The task of the special litigation committee is to determine whether a suit brought against the directors is in the best interests of the corporation or not. The common outcome is that special litigation committees determine that the suit is not in the best interests of the corporation and therefore should be dismissed. Depending on what jurisdiction you are in, that recommendation will be given deference ranging from complete to almost none.

Our paper was intended to see whether this package of doctrines which limit the legal liability of directors had an economic rationale. We wanted to focus somewhat on the American Law Institute Corporate Governance Project because that, in a sense, embodies many of the proposals for reform that have been made over the past few years to strengthen the role of legal constraints on corporate behavior.

We thought it useful to do something which, to the best of my knowledge, has not been done in the previous literature, and that is to analyze the nature of liability rules in the corporate context in relation to an emerging literature on how different types of contracts are enforced. For some types of contracts, resort to the courts to ensure contractual performance is an essential governance mechanism. Other types of contracts tend to be more self-enforcing. Parties devise alternate ways of enforcement because the costs of having legal rules as the primary method of enforcement relative to other methods of ensuring enforcement are too high. In noncontractual situations, primarily involving government officials, there are also doctrines limiting the scope of liability, and there has been some discussion of what is the economic rationale of limitations of liability in that context as well.

We found that for a variety of reasons many of the characteristics that have been identified with contracts where third parties, such as the court, only play a relatively minor role in assuring contractual performance are also present in the context of publicly held corporations. We also discussed some of the special problems that exist when the party doing the enforcing has a very small or, in many cases, virtually nonexistent stake in the firm. So there is a logic in terms of this package of doctrines in the corporate law of limiting the ability of shareholders, particularly shareholders with a small stake in the venture, to sue corporate managers, and these restrictions on liability may very well have a distinct economic rationale.

SCHWARTZ: I believe what Messrs. Fischel and Bradley are doing is urging the end of liability rules and derivative suits although by means they don't explain. Since the most that can be said against these rules is that they often have high costs and are not as effective as one would hope, and perhaps not as effective as other monitoring devices, the conclusion that would be appropriate from that is that we ought not to overvalue their significance, we ought not to abandon other methods of monitoring, and we certainly should not believe that there is no longer a need for a thriving market for control because there are derivative suits to monitor management. The correct perception is that derivative suits, liability rules, and tender offers all contribute to reducing agency costs.

FISCHEL: We are in perfect agreement that many monitoring devices exist and there is no reason that some have to continue or some have to be eliminated. Our point was that given the economics of liability rules in contractual settings, certain attributes of publicly held corporations, namely efficient information markets, and the other things we talked about, we are not surprised by existing rules which, as a package, make it harder to sue directors and hold them personally liable than it is to sue other people in other contexts. The differences between corporate law and other types of law are well rooted in fundamental economic principles. The widespread perception shared by many in the ALI project and elsewhere that the relative unimportance of liability rules in the corporate context is a problem is, at the very least, not an obvious position and, on balance, is probably an incorrect position.

SCOTT: The normative implication of your paper is that the status quo is optimal, that there is no reason to change from it. Correct?

FISCHEL: No reason has been demonstrated.

BRADLEY: I feel somewhat, in this situation, as I did about the ALI proposal against mergers and acquisitions. There is an issue of what is broken that needs to be fixed. Comments were made about the ravages in the market for corporate control and all of the abuses, but there has been no articulation of the problems at hand. The ALI proposal on derivative stockholders' suits, I think, is even less articulated. There's a notion that we want to strengthen the rules on duty of care and duty of loyalty to make them much more effective. What we are arguing in this paper is that in the absence of any egregious problems or issues that we are unable to find, we would maintain the status quo. We are willing to be convinced, or at least influenced, by evidence that would argue for change, but we are unconvinced right now.

FISCHEL: Status quo is a little bit of a misleading term, because we are not suggesting that firms be precluded from changing their set of contracts that they have now or that different jurisdictions evolve different rules over time. That process seems to have worked reasonably well. There is no evidence that we can identify that the problem alleged by people who want to strengthen liability rules is in fact a problem. The evidence, if you wanted to weigh it, would probably be to the contrary, that there are good reasons why liability rules are less important in a corporate context than in other contexts. Therefore, in this aspect of the ALI project as in, for that matter, all other aspects of the ALI project, we see no purpose in codifying a set of rules in response to a nonproblem.

GOETZ: If you put the null hypothesis that these liability rules ought to be rejected and done away with, then I would reject that one and say not proven. But I'd also reject the contrary one which is that they are really wonderful things. I think that's equally unproven. Fischel and Bradley really address that question and confront us with it.

II
Benefits and Costs of Derivative Suits

A. Deterrent Value of Derivative Suits

Demsetz: I don't recall finding any treatment in the Fischel-Bradley paper of the other side of the question—the pay-off from behaving against shareholder interest. The potential profit from misbehaving may be much larger in the case of corporate management than it is in the case of a doctor, which might imply that you still need lots of avenues of protection. Because a doctor fouls up on an operation, he can't walk away with $50 million to Brazil.

Scott: The loyalty cause of action is simply one piece of an extremely complex structure of incentives that bear on management of a publicly-held corporation, but it can be useful. The question is, "What is the alternative?" One alternative that Dan and Mike advocate would be to leave it solely to market sanctions. One market sanction would be that of the capital market. Takeovers are, I think, a rather inefficient way to limit management quasi-theft. They deal with a broader issue, the overall performance of the management of the company, and they are more costly to undertake than a derivative suit. With the fate of takeovers currently in some doubt, I think they are becoming even less of an answer. The labor market is another response to which Dan points. It seems to me that salary reassessments in the managerial futures market have rather weak implications for executives at the end of their careers, which includes most of the people running the publicly held corporations. There are theoretical responses to that kind of a problem, like bonding and so on. I don't observe their taking place to any significant degree.

The main point is, I don't see that these mechanisms are mutually exclusive. I don't see any reason why you go down a list and say this is more important and this less, and then take everything at the bottom of the list and say let's throw it out, let's automatically discard it. Loyalty violations are often secret and concealed as much as possible, and one of the benefits of the loyalty derivative suit is that it provides incentives for discovery by the plaintiff's attorney and recapture. That tends to push management toward overt compensation, and on overt compensation the other market mechanisms, it seems to me, can more effectively function.

SCHWARTZ: The market for control can be skewed without judicial intervention. I agree that the suits have not always, or even generally, responded very well to the problems that are created by managers who try to create impediments to take-overs and proxy fights and the like, but I just think that we would be worse off without liability rules and enforcement. I also think that the information markets, which it is contended serve us well here, don't function adequately to monitor. We are talking about transactions which basically are not revealed, indeed have further been concealed, and one needs bloodhounds with proper incentives to ferret out those deeds. Although the transactions are not material on a stand-alone basis, ignoring them can undermine management's dedication to the corporation. Moreover, much of the litigation involves corporations to whom the market is not nearly so efficient. Not even the semi-strong version of the efficient market theory would be applicable because many of them are companies that are not widely followed. I think a case is made in the ALI documents for the value of shareholder litigation. Potentially valid suits can be nipped in the bud by the defendant's action themselves through the special litigation committee.

There may be frivolous suits being brought. That is a very costly experience for corporations and there ought to be some way of more effectively monitoring that sort of thing. The plaintiffs' lawyers, who make the thing work, have to be subjected to a closer scrutiny and, perhaps, discipline, than they now are. Those are pretty serious failings in the operation of derivative suit mechanisms, and it is useful to try to address them by a set of rules.

I think that the case is not concluded by Michael and Dan's argument that the existing set of rules have an economic rationality and that therefore we ought not to try to change the results.

B. The Costs of Derivative Suits

1. *Managers as Inefficient Risk Bearers*

MANNE: The point is made frequently in various contexts that if you have such a rule, there is a danger that you will do more harm than good. You do good by punishing people for their mistakes, but you also do harm by preventing them from taking any risk. We know from other literature that there is a considerable problem in the corporation of coordinating the shareholders' preference for risk with the general risk averseness of managers. It seems to me that that ought to be examined precisely in this context.

MACEY: One negative aspect of imposing liability rules is that managers are particularly ill-equipped to handle firm-specific risk. That is, managers can't really diversify and, to that extent, if we impose liability rules for, say, negligent conduct on them which they can't diversify away, and don't allow them to contract around them, it's an inefficient thing to do. To the exent that they can insure themselves they will, but if they can't they are not particularly efficient risk bearers.

FISCHEL: I don't think that is right. The fact that managers are ineffcent risk bearers means that there is a cost associated with making them bear risk. It doesn't mean that it's inefficient to make them bear risk.

MACEY: If you've got a choice between having the risk of managers' negligent behavior fall on the shareholders who can diversify that away or fall on the manager who can't, and the shareholders can bear the risk in a much less costly way, then given the ability to contract in that regard, it seems to me that they will. To the extent they can't, it's inefficient. There is a relationship between the increased cost that you talk about and the efficiency aspect.

2. *The Role of the Business Judgment Rule*

SCHWARTZ: The Fischel-Bradley paper misstates the problem and the likely reaction of courts to risk taking. It suggests that the courts tend to punish those who are the cause of those bad decisions and that simply is not the case.

Obviously, we don't want to make managers so gun-shy to take risks that it disserves the interest of investors. The way the law has tried to accommodate that is through the business judgment rule, which is almost at the centerpiece of the principles that govern the conduct of corporate managers. That rule makes judgment decisions that have been made by directors virtually immune from liability. In other words, I don't think bad results produce litigation. Dan and Mike don't think that they should, I don't think that they should. Moreover, I don't think there is anything in the ALI documents, certainly in TD 3 or TD 4, which has just been published, which in any siguificant way diminishes the protection of the business judgment rule.

MANNE: The ALI "rational basis" test is a tightening up of the standards that directors have to meet when confronted with a charge of breach of duty. How much in terms of lost risk-taking is that one word going to cost shareholders in America? That's the question.

SCHWARTZ: Henry, I don't think the formulation of the rule you find in the ALI's draft in § 4.01 is different from existing law. I can show you numerous Delaware decisions that precede the draft of § 4.01 that expressed the business judgment rule in those words, or sometimes in words that seem to impose a higher standard on directors. It's a question of what you mean by having a rational basis and how you try to illustrate that. The ALI has sought to illustrate it, I think, by examples that show that it does not impose a very exacting standard on directors. It's not even that the directors have to stand a test that what they did was reasonable, but just that they had to "rationally believe" that what they were doing was acting in the best interests of the corporation. That's essentially the test as it is contained in the latest draft of the ALI provision that was circulated a couple of weeks ago.

SCOTT: Has there been any change in the investigation and inquiry predicate for that belief? That was the part that troubled me in the former draft.

SCHWARTZ: The first version, which goes back to about 1982, insisted upon a duty of inquiry on the part of the directors. Now, the director has to be satisfied that the inquiry that he has made, or the information that he possesses, is sufficient, but it doesn't require, necessarily, a separate undertaking to investigate. An example of the way that would be applied is the recent Delaware decision in *Smith v. Van Gorkom*[1] which involved a shareholder suit based upon a merger of Transunion Corporation with one of the Pritzker corporations, in which the Delaware court seemed to fault these directors for not having made sufficient inquiry. I believe that under the ALI formulation *Van Gorkom* comes out the other way, because I think that you don't need to have a separate inquiry on the part of directors who are as well informed and as experienced with respect to the affairs of the company as that board was. If you were presenting to a board that didn't have that kind of experience, some kind of an inquiry would be appropriate. But the predicate for the application of the business judgment rule is that the board believe that it's informed rather than that it undertook a separate inquiry.

MANNE: It's ironic that you say *Van Gorkom* might have gone differently under the ALI formulation, since many people believe that that case is actually a response from Delaware to the kind of criticism implicit in the ALI proposal.

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1 488 A.2d 858 (Del. 1985).

MACEY: I've never made a count of how many times the phrase "rational basis," "reasonable basis," or "inquiry" appeared in the opinion, although I am tempted to do so. At the very least it indicates that the ALI draft is vague and perhaps misleading. I think that the court was making an honest effort to apply what they believed the proposals to be and perhaps one might advocate that the case at least deserves some mention in the ALI proposal in order to distinguish how the case should come out under its rule.

CARNEY: Most lawyers in the room found the *Van Gorkom* case a real shock, where the rational basis test was applied with a mechanical vengence. The *Van Gorkom* case was one where good results produced litigation, which is about as perverse a result as I know of. It involved the sale of the firm at a major premium, which I think was 40% over the market. Some shareholder, after the fact, thought perhaps there was more to be gotten, and decided to bring litigation to see if he couldn't personally get something more and restructure the bargain. This is the trouble with moving into uncharted waters, whether it's a rational basis test or language like that, that implies the same notion of some kind of bureaucratic procedure.

SCHWARTZ: Bill, the issue was not whether that transaction was rationally based, but rather whether there was adequate inquiry. The rational basis test is not at all in issue in *Van Gorkom*, but just whether they followed the right procedures in dealing with the transaction. Insofar as being able to recover anything, that hasn't even been decided. Now the case has to go below, to the Court of Chancery, where the plaintiff has to prove that they suffered damage from that transaction, which is pretty dubious. Rational basis is simply not the issue in the case.

MANNE: Except the two converge. At some point, an implicit decision to adopt a practice or procedure, as in this case rubber stamping everything the CEO did, becomes a kind of substantive decision. You can say it's process, but it doesn't look too different, when you read that whole case, from the way the same court might talk about a charge that they didn't get enough money in the sale.

SCHWARTZ: If we didn't have a rational basis test at all in the statute or in the standard the court was following you'd still have gone through the same analysis. Therefore, rational basis doesn't contribute to the problem in this case.

CARNEY: I quote (from the opinion):

> "Indeed, the record compels the conclusion that the directors had no rational basis for expecting that a market test was attainable,

given the terms of the Agreement as executed during the evening of September 20."[2]

FISCHEL: The *Van Gorkom* case illustrates the danger of strategic behavior by minorities of trying to disrupt transactions which are obviously beneficial to shareholders as a class. It also demonstrates the related point, how doctrines which sound very good—you should only make a decision when you are informed, which is innocuous in itself—can be completely perverted by a plaintiff's attorney and a judge to reach an outrageous result. Those dangers are not confined to derivative suits. In all kinds of other suits you have this problem of a real risk of strategic behavior of somebody who can make an argument which is wealth increasing from a private point of view, but is quite costly to the supposed beneficiary, whether it's consumers or shareholders.

SCOTT: Just an addendum on the *Van Gorkom* case. There's a kind of irony in it, because the petard on which *Van Gorkom* is hoist is the Wall Street investment banking version of the world in which firms' inherent or intrinsic value is not to be found reliably indicated in the market price. That's the underlying, and faulty, premise. I don't even have to get to the problem of whether they applied the right rule.

WEISS: There have been a number of remarks made that suggest that *Van Gorkom* is a typical "strike suit." It's at least worth noting that the plaintiffs involved and their families owned something in excess of $2 million worth of stock. So, I don't think that's a fair critique of this plaintiff in this situation in terms of a typical "strike suit" plaintiff. Aside from that, I really think the characterization of the case as one that appears to track at least the previous version of the ALI project is an accurate one. Indeed, it seems to me that whether it was the intent of the court or not, one could not think of a more devastating critique of the previous version of § 4.01 of the ALI project than what the Delaware Supreme Court did by handing down *Smith v. Van Gorkom*, in terms of the process oriented approach that the ALI was recommending and the kind of silly results it's likely to lead to.

C. Distinguishing the Duties of Care and Loyalty

SCHWARTZ: I believe that the objections that Dan and Michael have leveled against derivative suits are premised on a model that costly decisions or shirking are the kinds of law suits that contain problems. But the real problems addressed by derivative suits are

2 488 A.2d at 878.

self-dealing transactions. Dan points out that not every self-dealing transaction is subjected to close analysis by directors or courts. The compensation agreement is the essence of a self-dealing transaction and yet we permit those kinds of transactions to go ahead. But there is a rule of necessity that operates here. Compensation is not a discretionary transaction in the sense that a corporation has to enter into some kind of compensation agreement with management. How else is it going to do it? While breaches of duty and breaches of loyalty can each cause harm, as the paper points out, there is not an equal temptation on the part of managers to shirk as there is to self-deal. Shirking can provide some more leisure to enjoy oneself, but self-dealing can lead to great riches. Therefore, the self-dealing transactions are in far greater need of policing than any other. Although I don't agree with the conclusion that therefore we could totally eliminate law suits based on the breach of the duty of care, I don't see that as a great tragedy if that were to occur either. It's not nearly as important as suits for the breaches of the duty of loyalty.

FISCHEL: The traditional discussion of the duty of care and the duty of loyalty in the legal literature is along the following lines: The duty of care involves situations where management makes business decisions without any conflict of interest, so therefore you need one set of legal rules for that, whereas the duty of loyalty involves conflicts of interest so you need another set of legal rules for that. Commentators have frequently echoed the same theme. That distinction in economic terms is a very strained one at best, because it is extremely misleading to talk about conflicts of interest as only paying yourself an above market rate of compensation. There are many other types of conflicts of interest which result from not being able to get all the benefits of good actions and not having to bear all the costs of bad actions. We talk about a few of them—consuming excess leisure, not concentrating hard. The various permutations are infinite. A conflict of interest is always present. Duties of care and of loyalty are simply different manifestations of the inherent conflict of interest in an agency relationship. Building on that, we do not see any basis for having a completely different set of legal rules based on whether the suit can be characterized as one or the other, because the nature of the characterization is extremely artificial.

Some of the differences that have been suggested relate to the amount of the gains that one can get from a large one-shot fraud versus simply not showing up for meetings over a long period of time. That is, for the most part, a fair point, although if somehow you could measure the cumulative deviation from performance which would maximize investors' wealth, it's not obvious to me, apart from this point about one shot fraud, that investors are properly more concerned about what I would consider to be highly visible forms of misconduct, rather than what is extremely difficult to monitor, the lack of diligence or effort, or whatever.

DEMSETZ: I think that Dan and Mike are correct. In a conceptual sense there really isn't much difference between duty of care and duty of loyalty in respect to who benefits and who is harmed.

On the other hand, the fact that these are conceptually the same does not mean that they are detectable in the same way. If you consider all situations in which the management of the corporation might benefit at the expense of shareholders, some may involve evidence that is much more suitable to adjudication in courts than others. The cases that come up under the classification of "duty of loyalty" are precisely those in which the nature of evidence required to find someone innocent or guilty is such that it is suitable for presentation in court. The cases that come up as business judgment cases are precisely those in which the evidence is not suitable. The argument favoring the derivative suit is stronger in those cases in which the evidence is suitable for presentation in court.

WOLFSON: I think it's clear, at the very least, you have a continuum. As you toughen the duty of care you inevitably, by any definition, move into the duty of loyalty area. The concept of fairness is very similar to a toughened duty of care. As you pay greater and greater attention to concepts like rational decision you move more and more into some "objective" truth that the directors fail to meet.

GOETZ: My position on the care/loyalty distinction is similar to Harold's, but we differ slightly. I agree that Dan and Mike are plainly correct at a conceptual level, but I am a little bit more aguostic at the practical level. I will put my position a little bit stronger now than I did in the paper. It seems to me a good thing for the law to create a kind of legal lexicon, to place labels on compartments of behavior, and then to see whether anybody finds those labels useful. I thought, although I don't have great familiarity with corporate law, that probably the distinction between loyalty and duty means something to people and can be drawn in a way that people know whether one duty is being violated rather than the other. If there are then practical considerations that might dictate the advisability of different treatment of those compartments of behavior, then I think it is fine to be allowed to treat them differently.

SCOTT: Having the courts try to monitor and sanction violations of some sort of care standard is simply not pragmatically successful and desirable. Sure, the care and loyalty categories at some high level of conceptual abstraction are all indistinguishable. They are all examples of agency costs. Nonetheless, the question is whether, operationally, there are some useful distinctions to be made here.

I think it would be an important clarification of the law and legal thinking to abolish care liability. I don't think that it would be an important change in outcome, because the actual imposition of care liability is a rare event. There are a great many ways of blocking the outcome of imposing liability for short-comings in performance. There are substantive rules like the business judgment rule; procedural rules like all the obstacles to the derivative suit, and deterrent-removal devices such as liability indemnification and insurance. But in the process of blocking care liability through all these different ways, it seems to me that there is a lot of doctrinal damage and confusion engendered, and I think it would be preferable, therefore, to choose outright abolition.

All of the reasons for rejecting care liability, on which I am in accord with Dan and Mike, it seems to me in large part do not apply to loyalty liability. The point isn't that loyalty liability or loyalty rules are a more important form of monitoring than monitoring of care. In terms of actual consequences for the operation of the economic system, it seems to me that in some large sense the care with which management performs its job is several orders of maguitude more important than loyalty derelictions. But that is not a reason for not employing a tool that is useful, even if it is a tool that is of limited usefulness.

Most, it seems to me, of the Fischel-Bradley arguments and data apply much more to the case against the care cause of action, and some of them, indeed, tend to support the loyalty cause of action. The difficulty of determining the cause, for example, of a business disaster, and of having a court make that determination, the danger of making managment too risk-averse in its business decision-making, the use of director and officer liability insurance to contract out of the liability sanction–all of those apply much more to the care situation.

The ALI position is that you should try to fine-tune the liability rules and the derivative suit procedures, make the Special Litigation Committee a little less of an automatic veto over every derivative suit, and so on. Is it worth attempting to go that route? I'm inclined to doubt it. I think the courts would be able to work with and administer more effectively, with fewer error costs, an abolition of care suits and a simplification of loyalty derivative suits. For me, the bottom line pragmatically comes down in favor of loyalty liability being maintained, and indeed somewhat strengthened, because it is a useful function that courts can fairly effectively perform.

FISCHEL: People still seem to be tenaciously clinging to the notion that we really need legal rules in duty of loyalty cases, namely financial conflict of interest cases. Presumably, everybody would admit the decision of what salary to pay yourself is a conflict of interest situation, but everybody realizes that legal contraints are relatively unimportant in that situation. Notwithstanding the absence of a legal check, directors are very sensitive to this problem, they have outside experts that they call in, and they are very sensitive to the competitive wage being paid by other firms. In other words, even in conflict of interest, or so-called duty of loyalty, situations, there are good reasons why firms can continue to operate in ways that are not obviously detrimental to investors without meaningful legal sanctions.

Another distinction that was offered is the notion of detectability, that certain things are more obvious and can be seen more easily. I think that is a correct point but, again, the important thing to keep in mind is that if it is easier for a court to see that a transaction is not at arm's length, if that is the example we are using, then it's also presumably easier for some of the internal monitors within the firm to see it as well. That is the explanation for the legal doctrine that disclosure to disinterested directors, again depending on the jurisdiction that you are in, either eliminates the possibility of judicial review entirely, or at the very least reduces the level of judicial review. There is a recognition that the function played by courts can also be played by monitors within the corporation and there is no special expertise of courts here. If anything, the opposite is true. If one wanted to push the point farther, one could say that the real problem with detectability is primarily duty of care violations, where it's very hard to detect flagging effort or not giving maximum effort. But we don't have a lot of suits in that area.

D. Evidence of Wealth Effects of Derivative Suits

1. *Review of Fischel-Bradley Study*

FISCHEL: We tried to get the best empirical data that we could to analyze the claims that investors are made worse off by legal rules which limit the exposure of directors and, conversely, would be better off if the scope of liability were expanded. We thought, analogously to all of the other studies along this line, that the most direct method of looking at that would be to analyze stock price returns rather than the number of suits filed or anything else.

What we initially had in mind was as sophisticated an event study as we could conduct, taking all of the different events in the context of a derivative suit—the filing of the suit on through to the disposition of the case. In fact, it was impossible to use the customary methodology of performing event studies, because the financial press did not report any information in connection with these suits. Initially we were very frustrated, but in talking about it we drew an inference that if legal proceedings in derivative suits were as important to protecting investors' interests as many of the proponents claimed, it was anomolous that the financial press which reported events relating to investors' wealth did not deem these suits significant enough to even have a line about them in the Wall Street Journal.

Not having any data from the sources that one usually looks at, we resorted to analyzing judicial decisions that we were able to find which met the criteria that were necessary, namely that they were firms that were publicly traded and therefore for which we could get the relevant stock price data. The results suggest that the wealth effects of derivative suits, no matter how they're decided, no matter whether the claim is based on the duty of loyalty or the duty of care, are, for the most part, relatively unimportant to investors.

BRADLEY: These data were gathered from court records and so our event date is the announcement of the court decision. It's not the announcement appearing in the financial press or even the popular press because we couldn't find those. Rather, it was right out of the Court ruling itself and the date decided was given by that. We are not saying there is absolutely no effect here. If you look at the signs of all the point estimates, all the ones where the suits were halted are negative, and where they were allowed to go through were positive. We report not only point estimates, but also fractions of the sample positive and negative. By and large, on the "halt's" the greater fraction is negative, and on the "allowed to proceed's" the fraction was more positive.

Then the question is statistical significance. By and large, there are effects here. After all, there is a bag of money being adjudicated; if the suit goes through, the stockholders do run a risk indeed of getting more money, and if it's suspended or halted they lose that opportunity. But what we see in these data are not huge valuation effects—far less than I personally, and I think we collectively, would expect, if indeed what was going on here was a fundamental, basic realignment of managers' interests with respect to those of the stockholders. Although we can see that there are some effects in these data, which gives us even more confidence that the data were gathered appropriately and that the analysis went through reasonably error-free, we don't think that these results are significant and certainly don't indicate a fundamental realignment of interests of managers and stockholders.

2. *Critiques of Study*

SCHWARTZ: The data does not prove the point. I doubt the ability of this kind of an event study to filter the noise and to identify and explain the reaction to the filing or the dismissal of a lawsuit. Too many things are going on. Moreover, the particular events that are being focused on, the filing of the suit and termination or dismissal of the suit, are ambiguous events. The filing of the lawsuit has significance if the suit has merit and is likely to lead to recovery. But at the time it's filed, it hasn't been subjected to that kind of analysis. Similarly, the termination of a suit would have a negative effect on shareholders, if what was being terminated was a suit that had merit. But again, it's much too early in the proceeding, in many cases, to know whether that's the case. Moreover, many of these suits should not be expected to have a profound impact on the price of the stock because, on a stand-alone basis, the suit itself tends to be immaterial. Furthermore, the filing of a suit or the dismissal of a suit pertains to an underlying event which has probably been made public and for which there may well have been an effect in the market price. Most important, the data fails to measure the deterrent value of derivative suits and of class actions.

DEMSETZ: Most of my comments are really about the lack of a theory underlying the statistical study. Finance theory generally has three potential forces at work in affecting stock prices. One of these is expected earnings of the stock. The second is the systematic risk of the stock—that component of the risk of a stock which, because it is correlated with the market as a whole, prevents risk avoidance through portfolio diversification. The third is firm-specific risk, risk that is associated with the performance of a particular company's stock, but which is not correlated with the market as a whole. People don't get compensated for bearing firm-specific risk because they can escape the risk by diversifying their portfolios.

If, for one reason or another, it's not so cheap to diversify portfolios, then the problems associated with the derivative suits and the derivative suits themselves may impinge on the stock prices, or they may affect stock prices by changing the expectations people have about future earnings of the stock. If these are the sources of interdependence between derivative suits (and the problems behind these suits) and stock prices, it seems to me that different statistical tests should be applied, although I don't think the data are rich enough to really do this. One ought to assess the degree to which the event of a derivative suit or the frequency of derivative suits or the decisions about derivative suits' impact on expectations about earnings or impact on expectations about the size of the firm-specific risk associated with owning that particular stock. This would require looking at whether the frequency of derivative suits for a particular company has changed from a historic pattern, which might give rise to a change in expectations either about firm-specific risk or about expected earnings.

GOETZ: A threshold question of mine was, "What was the magnitude of the effects that we were looking for in the first place?"

After getting over the threshold question of new information and the magnitude of the effect we were looking for, I then began to ask myself what effect I would have expected theoretically upon dismissal of one of these suits. My own answer was, "Well, it all depends." In some cases it would make the stock go up and in other cases down. It depends, for instance, on whether you're talking about management which has already departed or if the suit has an impact on future profitability. If I understand the Fischel-Bradley study correctly, that it averages over the observations, it occurred to me that perhaps we were seeing positive results cancelling out negative results. There is another conclusion that might be drawn from their study: What are the results if one ignores algebraic sign, and simply asks whether something happens when these events occur?

After I reflected properly on how unhappy a job it is to do empirical research anyway, I invoked the Great Provider of Information who would come down and settle this question for us. Probably what Fischel and Bradley would have preferred to find in line with the tenor of all their theoretical discussion was that a dismissal of a stockholder's derivative suit would increase stock value, showing that these suits are not cost effective. However, I wasn't sure what normative conclusion to draw from that. If you adopt a game strategic approach to this, it is entirely possible that, once a corporate manager has cheated, the enforcement process at that point is not cost effective. But that doesn't suggest that the stockholders wouldn't want to subject management to an effective threat. Dan and Mike's point about the minority rule and the fringe stockholders can be turned against them, at least hypothetically, by arguing that people who are kind of "crazy" arguably serve a useful function. They present the management group with some finite probability that somebody out there will sue whether this is cost effective or not—and that deters the very conduct that stockholders are trying to regulate in the first place.

SCOTT: Charlie Goetz points out that you can construct a rather plausible game model in which negative abnormal returns to the shareholders from bringing a derivative suit are, nonetheless, consistent with the shareholders' best interest ex ante. I would add that making that model work in a real world would not depend on crazies, or shareholders somehow conspiring together to mount collective credible threats, or anything like that. All it depends on is rational, self-seeking, plaintiff's attorneys. The plaintiff's attorney, for exactly the reasons Dan objects to, is concerned with whether he can make the individual lawsuit pay off for him, not with whether it has for the firm as a whole and for the shareholders as a whole, an actual negative effect. So the attorney in the derivative suit is a splendid solution to your problem of how do you mount a credible threat or how can you count on there being a crazy out there who will sacrifice himself for the ex ante good of the others.

Fischel-Bradley actually found that dismissals in derivative suits are negative events for stockholders, and I would add that they are more negative in the case of loyalty suits than in the case of care suits, at least on a repartition of the data that I undertook. On the first sample you had, when you sent me the printout, I did a loyalty/care breakdown and found that I got essentially the same results although somewhat different magnitudes. The loyalty cases, as you reported, were negative on dismissal, positive on continuance, etc. On the care suits, the signs reversed. I found that dismissals were positive abnormal return events and continuances were negative. Then when I made that same kind of run on your second enlarged sample, the effect didn't completely disappear, but weakened. What I found was that on the loyalty dismissals, I got a larger negative abnormal return than for the group as a whole, and on the care dismissals, I got a smaller one. I also noticed that when I did this recheck, I didn't come out with characterizations that matched yours terribly well. There is the question of how you make that characterization when the lawsuit may contain a number of counts. In the separation criterion that I used in running that check, I didn't particularly want to depend on the court's choice to call or not call something care or loyalty, or happening to use that word in the text or not use it. What I was really looking for in the opinions in order to make the characterizations was whether there was some allegation of a direct monetary benefit obtained by the defendant, which it was the object of the lawsuit to recover. On that basis I made the care/loyalty distinction, and I still found this distinction between care and loyalty, although not as powerfully as on your first sample where it actually caused the signs to reverse.

CARNEY: I want to express some fairly profound skepticism about these event studies. We are dealing with very complex events. Even reasonable lawyers disagree about the impact of the decision on the range of behavior available to management in the future. Certainly corporate counsel trying to advise their clients about what they can do are going to go through an awful lot of agonizing and hand-wringing in the process. To expect the market instantly to be able to predict the wealth effects of these judicial decisions is a fairly heroic kind of assumption.

DEMSETZ: I'm not clear, exactly, what your statistics would measure. Let me give you an example of measuring something different than what you think they are measuring. Suppose there is a company that is tied up in litigation on one of these suits. The management is somehow occupied with this, and the suit gets ended. The stock price goes up, not because the decision is good or bad, but because management doesn't need to mess around with this thing anymore and the uncertainty of it all is eliminated. How do we interpret the rise in the stock's price?

RIBSTEIN: A follow-up on Bill Carney's point. It's not just the wealth effects of the decisions that are unknown but on a more basic level, the precedential value. We argued some time about what the *Van Gorkom* case says. Unless you know that, you obviously can't make any determination about the wealth effect. That's going to be a problem in any of the event studies that study the effect of the decision on a range of stocks.

MANNE: Let me add that if the lower court now comes back with a no-damage result in the *Van Gorkom* case, we really are not going to know what it means. It may be a signal that the case has no precedential value and that this demonstrates second thoughts about it. Or it may be thought that in the next case you can collect $60 million.

But I want to raise a different kind of issue about this. There seems to be another problem here that can be related to an ex post/ex ante distinction. Even when you find the positive financial result—which is not too surprising whenever the company has a real probability of collecting a lot of money—you still don't know that the probability of such suits being won by future plaintiffs may not reduce the value of all other stocks on the market. And that reduction could vastly outweigh the benefit to the shareholders in this company. So even if you find a strongly significant positive sign as a result of these suits being brought and not dismissed, you still don't know, empirically and as a matter of general welfare economics, whether the derivative suit is a good idea or not.

GOETZ: The argument could be made that the social value of the suit was the addition of the two, without regard to sign, because it's the price differential that keeps the two kinds of assets in equilibrium that measures its value. I think that Robert Stroh has written an article which addresses the same point, and I believe came up with the price differential answer.

MANNE: I can see that as a way of measuring the value of the rule, but that's not what we are doing here. Here, you've already got the rule on the book, ex ante, with the court deciding in the specific case that it will be applicable. But that affects how everyone else ex ante sees their stock being valued in the future.

3. *Response to Criticism*

BRADLEY: Someone mentioned that perhaps what we are seeing here is a situation in which half of any one particular sample is a positive result and the other half is a negative result, and what we are seeing is a washing out of those two effects. I did include a percentage of positives and negatives. If you look at those numbers, you will see that the positives outweigh the negatives when the point estimate was positive, and the negatives outweigh the positives when the point estimate was negative. I can assure you that there is no one firm driving those results, there is no one firm that stands out significantly. In fact, you have to get the portfolio diversification effect before the standard error gets small enough to be significant.

We certainly recognize that derivative stockholder suits fall within the definition of firm-specific events. But that doesn't say that they're not going to be priced out in the capital market. Firm-specific events and firm-specific risk will not be priced out ex ante. Clearly, the argnment is that stockholders can well diversify that type of risk on their own account. But that's not to say that when such firm specific events happen, there will not be a stock price effect. Clearly, we are not compensated for the risk of fire for most corporations that we hold, because that is diversifiable risk. However, when a fire does occur, the value of that firm does drop precipitously in the absence of any insurance. A tender offer, on the other side of the ledger, if you will, is a firm-specific event. That doesn't mean that when somebody offers a premium of 50 percent of the share, the stock price isn't going to respond to it. It's just that it's not priced out ex ante, so it's unexpected. There should be enough positives to outweigh the negatives. That's the nature of diversification, and that's why it's not compensated ex ante.

The points made by Harold and Don about expectations and modeling and what you expect going into the data are excellent points, and it does scream for the absence of a theory as we go into these data. But at the same time, we do expect that, to the extent that the derivative suit is a firm-specific event, we should observe some stock price behavior.

DEMSETZ: A derivative suit will impact stock price only because it impacts expectations about earnings. If firm-specific risk increases, say as measured by a greater variance about the same mean expected earnings, stock price should not be impacted if you can diversify out of the risk.

FISCHEL: We agree with virtually every criticism of the empirical work, but I don't think we would, nevertheless, say that it necessarily could be done any better, and more importantly, that we are not comfortable with the conclusion that we draw from it. Notwithstanding all these criticisms, we interpret the facts that there is no public disclosure of events relating to derivative suits and that there are very small wealth effects associated with derivative suits, no matter how they come out or what theory they are based on, to suggest that they are not very important to investors. You can quarrel with what "not very important" means, but nevertheless I think that it is something that we now know, by virtue of this data, that we didn't know before the data existed. Notwithstanding all of its infirmities, I think it does shed light on the ultimate issue being addressed. Therefore, I think it's a valuable part of the study.

TULLOCK: I regard Fischel and Bradley as having produced a statistically valid demonstration that the derivative suits do affect these things. In the t-testing experiment in the beginning of Fisher's design of experiments, he required only four proper signs. They have, on decision day, six observations with the "right" sign, on decision day plus one day after, six with the "right" sign, and on decision week, five with the "right" sign and one "wrong." That impresses me as a fairly strong significance test. Admittedly, the effect is small, but it seems to me they have demonstated that the derivative suit is something that stockholders value but not by very much, perhaps.

4. *Comparison with Data on Wealth Effects of Mergers*

LEFTWICH: I heard a lot about how difficult these cases are to evaluate. I think that whenever you work on a problem, it seems that those problems are worse than the ones everyone else faces.

I don't see in principle how the data are any worse here, or the expectations problems any greater, than other studies in, for example, the merger area, where, in one case, we're prepared to believe the numbers out there in the market.

There's a natural tie-in here with mergers because the hardest thing to come to a conclusion on is the activities of bidding firms.

There is a debate about the sign of those gains, if any, and that is precisely because of the capitalization issue about expectations. That's a function of whether or not the firm has a reputation for doing this, what you learn about the management as the whole process unfolds.

BRADLEY: There is an analogy with mergers and acquisitions. People familiar with mergers understand that the actual announcement of the merger typically precedes the consummation by maybe up to eighteen months in some cases. We are jumping in, knowingly, in the middle of a phenomenon that we'd like to go back on. Mergers and tender offers are very complicated things, yet we still expect the market to sort that out.

MACEY: In terms of Richard's comment about the analogy between the kind of data presented by Fischel-Bradley and the data on mergers, the Fischel-Bradley data is much more important in my view than data on mergers. If firms are losing money by making these bids, then market forces will discipline those firms. In the derivative suit realm, though, where both the filing of the derivative suit and the course of the litigation itself are outside of the controls of the firm, and outside of the control of market forces, the kind of study that Dan and Mike are doing takes on much greater significance.

ALCHIAN: About the similarity between this study and the merger study, the question asked in the merger study was, do stockholders of the companies involved in the merger or takeover suffer? It seems that they do not. Certainly, the ones on the target side seem to benefit, and as to those on the takeover side, there is evidence that they don't suffer and may even get a benefit. A separate question, though, is, does permitting mergers to occur, as a whole, help stockholders? In other words, would it be better to have an economy in which mergers were not allowed? Now the difference between that case and the present one is, I have a theory which suggests that if you didn't let them occur, there would be damage to stockholders. I have a strong theory on that proposition. That's why I don't have to go back and make the second attempt. In this case, we haven't that theory yet.

CARNEY: A merger is a trade, a voluntary transaction. We always expect there to be gains from trade. I don't need to know much more than that to expect there will be some positive stock price reevaluations on both sides. When we start talking about derivative suits, we are no longer talking about voluntary transactions, or exchanges or trades. We can't predict the sign in terms of the outcome of a particular derivative suit. We get some information. In some cases it's fairly weak information, and presumably the market will discount it because of enormous uncertainty about what it means.

MANNE: While I agree with Armen that the theory we have about mergers and the market for corporate control is stronger than the theory we have in connection with derivative suits, my agreement is not one hundred percent. There may still be externalities that are difficult to capture in our measurement because all of the measurement tests, just as in a derivative suit, are addressed just to the effect on the shareholders of the target company. There may be effects that we don't understand on all other companies in aggregate as a result of these events.

5. *The Problem of Timing the Effect on Market Price*

SCHWARTZ: Mike mentioned earlier that a study of mergers focusing on the consummation date of the merger was not significant because the significant event occurred quite a bit earlier. Therefore, the consummation was an anti-climax. To some extent, isn't that true also with the filing of a derivative suit? That is, it's an anti-climax to an event the underlying facts of which were revealed much earlier.

One example is *Texas Gulf Sulphur*.[3] There were private lawsuits filed against *Texas Gulf Sulphur*, class actions as a result of the insider trading case that the SEC had launched. I would doubt that the filing of the class action suits from *Texas Gulf* had much of an impact. I wonder if you don't have to look back at the event when it was first disclosed to see what the anticipated market reaction was, rather than to look at the anti-climatic event, which may have the same kind of relevance as the merger consummation date or the actual announcement of the merger.

For example, Bhopal is a significant event. When Melvin Belli files a lawsuit against Union Carbide, that event, I would think, has been fully reflected in the market price.

SCOTT: I think Bhopal is exactly the wrong illustration. In Bhopal, the event signals a loss to the corporation. The lawsuit merely confirms that that process is taking place.

What you are talking about here, at least in many instances, would first be an event which is a loss to the corporation, in whatever form it may take. Then you have a lawsuit, the purported effect of which is to recoup that loss to the corporation. If the cer-

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[3] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

tainty of recovery from the derivative suit of the full amount were at the level of one, so that the company was going to be made whole for the loss, then what you would see on the initial event would be a very minor loss or none at all, because if the legal system is going to provide it with full recoupment, with appropriate interest, no loss has taken place. The lawsuit is going to fully redress the matter. What we can expect to see here is that there isn't an anticipation of full recovery from the lawsuit. You can therefore trace a series of events. The filing of the lawsuit gives you a certain possibility of a recovery and then, as different events take place and uncertainty is resolved, the expected value starts to change. You have a dismissal motion that is ruled on, you have an appeal of that to a higher court that's ruled on, and even if the magnitude stays the same throughout, you are shifting the probability and you are going to be able to pick up the signs. One of the interesting things in the Fischel-Bradley sample is that, in several cases, they actually have the same lawsuit proceeding through the courts at different stages and you can compare the market reaction among other things for consistency. When you have the dismissal granted, for example, is that a negative or positive event? If the dismissal is affirmed, then that should have the same sign. If it's reversed, you can see if the sign is opposite. Furthermore, you can get a little better fix on magnitude. If all you're picking up is magnitude at one stage in this process, then you have no reason to think that's the full order of magnitude. It's being spread over a series of events and probability reassessments. You get a little better fix on magnitude if you start to add up these different stages. You are never going to get a full measure of magnitude. As Dan and Mike were saying, you'll get a somewhat better understanding of the parameters of your world. You don't get a perfect measure.

FISCHEL: The theory that we've heard about derivative suits is that a lot of these actions are clandestine, secret profits that need a private attorney general to discover them. Obviously, if that is the theory, then something that is so widely disclosed is not going to be a good example of the justification that's being asserted for derivative suits. Once something is publicly disclosed, the value of a suit is very, very small, even as a deterrence measure, unless you are going to tell the story of the 64 year old manager with no final payments, no lost pension, or anything else. At the end, the market penalizes people, once things are publicly known. So, it's precisely in those examples where something is publicly known and you have a lot of leakage that the deterrent value of the suit is the least important. Those are the kinds of cases where the world would probably not look much different without any suits. It's only in those circumstances where you need somebody to bring information to bear about managerial misconduct that is not already known to the market that you can tell a good theoretical story for justifying derivative suits.

6. *Is the Market Efficient?*

WEISS: It seems to me that not only a lot of literature, but a lot of the discussions that we've had today, have assumed the efficiency of the market in the sense of the capability of the market rapidly both to obtain and to interpret accurately very complex information. Are we now questioning the whole efficient market hypothesis as applied to this sort of information?

DEMSETZ: I think the rejoinder to Elliott's question is that, from the viewpoint of the investigator, evaluating the evidence bearing on a specific point of interest is very complex. There are lots of things involved in the evidence, including some reaction to the event by the persons involved. This in no way says that the market isn't putting a fair estimate on the total bundle of effects. So you could have the efficient market pricing these things on an expected basis appropriately and still make it difficult to ferret out the evidence that you want for this manuscript.

ALCHIAN: In Weiss's question, he used the word efficient. It doesn't mean that the market doesn't make mistakes, it means that the mistakes have an average variant of zero. Also, it means that information available now is fully reflected in the market, in the sense that you can't expect any trends to occur. It would be better if we abandoned the word efficient and used the word unbiased.

7. *Suggestions for Further Empirical Work*

BRADLEY: We make the point in the paper that there is a bag of money on the table here, and as the suit goes, presumably so goes the bag of money. What we would like to have done here would have been to gather the facts of the cases as to what is the magnitude of the bag of money. For example, a lot of studies on greenmail have done this. I would recommend an extension in this area to put that money into the analysis and see if there is any inference drawn. After all, we were looking for more than just the bags of money on the table; but, rather, does this have implications for future production and investment decisions?

In that same regard, if there is a deterrent here, we may be missing something. Jon's doing a study, and Dan and I are doing similar work, looking at the effect of the *Van Gorkom* case. This type of social experiment, namely Delaware v. nonDelaware, is another line of extension that I think is very worthwhile.

PASHIGIAN: It would be nice to know if you took a sample of other firms in the same industry and ran exactly the same test and did not find a result that you are reporting here. Then one could be certain that you are getting an effect attributed to the court decision.

DEMSETZ: Why wouldn't that be just verification of the lack of spillover into other firms in the industry?

PASHIGIAN: That's right. That would also be verification that the ruling does not cover all firms in the industry. That leads me really to the second point. You might find that you are going to get comparable effects, which would be consistent with the idea that the ruling is now inferred to apply to all firms in the industry.

MANNE: It depends on the nature of the case. It may be that you want to look for your check at a set of firms whose plants were in the same location if the complaint was related, say, to environmental issues or something of that nature.

BRADLEY: The issue of the overall deterrent effect would be worth pursuing.

ALCHIAN: I was going to ask if we could perform an idealized experiment. Suppose the states differed in their attitude toward derivative suits. Could we get that kind of data from the states with and without to see if the rates of return differ between the two?

FISCHEL: There are some states where the special litigation committee is given complete discretion to dismiss the suit, other states where the special litigation committee is given no discretion to dismiss the suit.

DEMSETZ: When did those differences emerge?

FISCHEL: Recently.

DEMSETZ: So that you could have an event study on emergence of those differences?

WEISS: In an event study I participated in, we looked at both *Maldonado* when it came down in the Chancery Court, which I think was a surprise, and we looked again at *Maldonado* when it came down in the Delaware Supreme Court. We didn't compare Delaware corporations to the market because there are too many Delaware corporations included in the market indices. We found no effect as to either of those decisions.

GOETZ: One thing that I want to propose, at least briefly, is whether organizations like the Business Roundtable and the ALI and even people like us ought to be exerting some sort of pressure on groups like the Administrative Office so that the right kind of data will be kept in the future. I think there is a golden opportunity right now. I recently had conversations with a number of federal district court judges, and they are all interested in computerized docketing and case management files. Apparently the Administrative Office is doing very little about a systematic policy on this. I would hate to think that three or four years from now every federal district court in the United States of America will have its own software and keep slightly different records for slightly different purposes. Since the statistics will not be kept on a comparable basis, empirical researchers will tear their hair looking for comparable sets of statistics. It's not worth doing a project like this, identifying what data should be kept, simply to resolve the question of corporate liability. But there are many similar questions about other kinds of legal policies and we simply don't have the facts. We have the opportunity now to give some guidance to the development of a system that five or ten years from now would enable us to address some of these questions with richer models.

E. Comparison with Other Countries

MANNE: To my knowledge, Germany, Japan, and probably a lot of other countries with substantial and successful corporate systems have no such thing as a derivative suit. Indeed, there is no liability for most of the things that we're talking about, and what liability there is, is criminal liability. They're getting along all right. I think we ought to examine why it is that they are surviving without such rules when we are saying in effect that we need a lot more of them.

SCHWARTZ: There is, I think, one distinction at least between German and American systems. I think our share ownership is much more broadly based than the German.

DEMSETZ: What's the cause and effect? If you have a different kind of liability system, you get a restructuring of the ownership of the corporation. That's not an exogenous event.

MANNE: Would you explain that? How might a rule of no liability result in concentrated holdings by bank agents?

DEMSETZ: Let's suppose you have a system in which corporate management is less likely to be found in violation of law for violating the interest of shareholders, that the courts just don't handle those cases for some reason or other. One of the consequences of this would be that the ownership structure of the corporation will become much more concentrated, so that the owners can, in fact, take care of themselves.

WEISS: Henry, your suggested cross-cultural comparison raises a host of very complicated questions. My impression of a number of those advanced industrial societies that don't have derivative suits is that in many of them, at least, there is also, for example, a much higher degree of government substantive regulation of corporate activity. At the same time, the idea of a corporation mounting litigation to challenge some government administrative action also is virtually unheard of. It seems to me that before one asks why they don't have derivative suits in Germany or Japan, one needs to look at a whole host of cultural phenomena as to the role of litigation, the relationship of government to corporations, the social contract, other social values, and the degree of uniformity that exists in those societies as opposed to the diversity of our society.

MANNE: Your point is well taken. It is precisely that kind of analysis that Fischel-Bradley were pursuing in this paper, trying to find those other factors here that should push us in one direction or the other. As for Germany, I doubt that German industry is suffering today under as many bureaucratic regulations as U.S. business. I can't say for Japan; one hears mixed stories, and I think they get a little bit garbled in translation.

III
OPTIONAL LIABILITY RULES

A. Forms of Opting Out of Liability Rules

PASHIGIAN: What is the cost of contracting out? Is it difficult, when is it expensive, when is it not expensive? And that's really a question of information on my part. I'm sure the lawyers here are better suited to explain why that is either very expensive, and therefore firms are unable to do that, or it isn't. And if it isn't, and we see firms not contracting out, why don't we say a liability rule is, in fact, part of an optimal portfolio of devices for limiting agency costs?

CARNEY: I'm not sure the courts would tolerate contracting out of duties of loyalty. That's certainly true in the trust area. The courts simply will not tolerate that kind of contracting out. You can contract out of the duty of care within limits in the trust area and I would predict that that division would carry over into the corporate area as well.

To some extent, we do see contracting out. In tax shelter prospectuses, for example, we see a long description of the conflicts of interest between promoter and general partner of the tax shelter and the investors that he's going to deal with. Clearly those disclosures are designed to put investors on notice that they are going to have to live with this particular set of problems under the duty of loyalty. I don't know how many lawsuits take place challenging the breach of the duty of loyalty later on in those settings, but the fact is that lawyers are trying to find ways to make disclosures, to contract out of some of those problems.

Corporate statutes provide for indemnification of officers and directors, which is one form of contracting out. You can do that within the limits of the duty of care cases, at least where there is a finding under the Model Act and a number of other statutes that the acts that the officer or director took were not knowingly against the interest of the corporation. Most corporate bylaws pick up on that langnage in the statute and incorporate it so that it becomes a standard part of the contract of all officers and directors in major corporations and even in closely held corporations. There's no such thing for the duty of loyalty violations. You simply don't have the ability to contract out of those by statute.

FISCHEL: With respect to this contracting out, it's a little more subtle than might appear to be the case. For example, a firm can significantly contract out of liability rules just by having a majority of independent directors or having at least enough independent directors who can constitute a quorum. If there is disclosure to them, a transaction which would otherwise be subject to judicial scrutiny will either not be subject to judicial scrutiny at all or will be subject to judicial scrutiny under a lower standard. The corporation's internal governance mechanism acts as a substitute for judicial enforcement. So there are a lot of things a corporation can do structurally to affect the probability that decisions made by the corporation will be challenged in court.

Much the same is true with shareholder voting. To take a classic case, let's say there's a sale of an asset by a director to a corporation, the board of which he serves on. It's not an arm's length transaction per se. Under traditional corporate law principles, that transaction could be challenged in court. Depending on what time you are taking about, or what jurisdiction you are talking about, it would either be prohibited or, at the very least, would be subject to a high level of judicial scrutiny. Now, let's say the corporation with the identical transaction is organized somewhat differently, so that the terms of the transaction, as well as the financial interest of the director, are disclosed to a group of directors who do not have a financial stake in that transaction. Those directors take the position that the transaction is beneficial for the corporation. If you have that second step, again depending on what jurisdiction you are in, that transaction will either be completely immunized from judicial review or, at the very least, subject to a lower standard of judicial review, simply because you have internal monitors who substitute for what the courts will do. So you can do a lot contractually ex ante to minimize the probability that decisions made within the firm will be challenged under fiduciary duty standards and reviewed by judges.

SCHWARTZ: I just want to comment on what Bill Carney said about indemnification, which is an example of contracting out to some extent. A number of corporations, beginning probably in the 30s, began to indemnify officers and directors against certain injuries or expenses that they incurred, so that if an officer of a corporation serves at the company's direction as an officer of another corporation, and is sued for some violation of the law or some breach of duty, that director can be indemnified by the corporation that asked him to serve. Specifically, in the context that we are speaking about, an officer or director who is sued for breach of fiduciary duty or breach of the duty of loyalty, for example, the kind of transaction that Dan just described, is allowed under the contractual provisions of the corporation in most jurisdictions to be indemnified for the expenses he incurs in that lawsuit. But, and this is in contrast to what Bill said, if he goes to trial and is found to have breached his duty, he cannot be indemnified under the corporation laws.

FISCHEL: Don's statement was correct, but it's incomplete. You can insure for the amount you have to pay in judgment in all duty of care cases and in duty of loyalty cases as long as you are not found to have acted deliberately.

SCHWARTZ: Dan, I think to round out the statement, you can't even insure against all of the breaches of duty of due care. The insurance company is likely not to insure against reckless behavior, which is maybe just an extreme case of neglecting one's duties. Also, you have to remember that the insurance companies will very frequently provide for very substantial deductibles on their insurance policies, $25,000-$50,000 in some cases so that there is still a substantial exposure to personal loss notwithstanding the availability of both indemnification and insurance.

WOLFSON: I guess you could view the whole debate over the litigation committee as whether or not the law, whether in the form of a judge or in the form of regulatory agency, wants to permit using the independent director as the ultimate opt-out device that would winnow out all loyalty cases.

SCOTT: I think it's useful to follow up on this opting out, which ties into indemnification and insurance and shows us why the answer to Peter's question is convoluted and in some ways uncertain. There's yet another factor, and that is that some of these indemnification and insurance arrangements may be subject to being questioned by the court and not allowed to be enforced as contrary to public policy in the view of the judge.

That happened in the district court decision in *Gould vs. American Hawaiian Steamship Co.*[4] where the director was serving on the board of Company "B" because Company "A" was a significant stockholder in Company "B". This was an example in my view of a judge who didn't understand the transaction, imposing liability improperly. In any event, he imposed liability on a personal basis on this director to the tune of $1 million. Then he denied any indemnification to the director from Company "B" for that liability and it was not at all clear from his opinion whether he would believe in permitting indemnification from Company "A" for that director. So you've got this "contrary to public policy" notion that impairs the enforcement of some of these indemnifications or insurance arrangements even if you think you have contracted for them.

MANNE: You slipped in that "or insurance" after discussing that case. Given what I recall of that case, I think it doesn't involve insurance.

SCOTT: It doesn't involve insurance, but it makes you wonder whether the judge would apply the same reasoning to an insurance policy. The SEC has taken that position with respect to indemnification and insurance under the 1933 Act.

FISCHEL: One of the factors that will influence what set of contracts you observe is how confident you are in how the person who is going to resolve the issues that come up under those contracts will resolve them. In a sense the set of contracts is not independent from the critical comments that have been made about judges. If you really did not have a lot of confidence in judges you would anticipate, for example, a lot of use of arbitration or other methods where you could substitute somebody with much more expertise than the judge for resolving disputes and opt out that way. Actually, I've been troubled for a long time about why there isn't more use of

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4 362 F. Supp. 771 (D. Del. 1973), *vacated and remanded*, 535 F.2d 761 (3d Cir. 1976).

that type of dispute resolution. So I think it is interesting to have some discussion about what the costs are of that form of dispute resolution so that people don't use it more frequently.

TULLOCK: I've been thinking about some new institutions using the public choice approach. They fit in perfectly here. Stockholders could vote on setting up a committee to deal with the possible derivative suit. Another method simply would be to use an accounting firm. There might be a specialized firm. As a third alternative, a group of fairly large stockholders who are not on the board of directors but who, if they are compensated once every five years when a suit comes up, would be a suitable mechanism. It would seem to me that this would be much cheaper and easier than a court procedure. As far as I know, nobody complains about the board of directors actually nominating an accounting firm, and the stockholder vote on it is pretty routine. It would probably be pretty routine on this too. The motives of the board of directors for not choosing an accounting firm that is well known to overlook embezzlement are obvious.

MACEY: My understanding is that, as far as the claims brought under the federal securities laws, Dan, you can't agree to arbitrate, you've got to go to court. I've heard data that the frequency with which derivative suits are brought against particular firms—like once every 18 years—is so low that the cost of engaging in an arbitration agreement that would cover that small set of claims would probably outweigh the benefits.

SCHWARTZ: The data that Jack Coffee has found shows that, I think, once every seventeen or eighteen years is the incidence of a derivative suit against any particular corporation.

DOOLEY: Just a short informational point. There are now two state statutes that permit the appointment of independent persons other than directors to function as a special litigation committee. In the Pennsylvania statute, there are quite elaborate provisions on the amount of deference the court has to give to their decision.

MOFSKY: There is a recent Supreme Court case, *Dean Witter v. Byrd*,[5] that contains a concurring opinion that suggests that the question of whether arbitration will be available to these kinds of cases is wide open. In his concurring opinion, Justice White casts considerable doubt on the proposition that an earlier case, *Wilko v. Swann*,[6] which concluded that arbitration was not available with regard to claims

5 Dean Witter Reynolds Inc. v. Byrd, 105 S.Ct. 1238 (1985).
6 346 U.S. 427 (1953).

under § 12(2) of the 1933 Act, is applicable to the 1934 Act. Thus, it may well be that arbitration will be compelled with respect to claims arising under the 1934 Act.

LEUBSDORF: I want to suggest that, in a way, some of the substantive doctrines are arbitration provisions. The corporate opportunities doctrine says that if a corporate opportunity is open to one of the directors or managers, it has to be presented to the board of directors which will then decide whether the director can proceed. The theory, I take it, is that you draft the jurisdictional scope of the rule very widely, so that almost any transaction in the relevant area will have to be brought to the board and the board will then decide. You don't have a system under which the directors and managers go off and engage in the transaction and then wait for litigation to occur. If you are a director or manager, and if there is any doubt at all, your course is to simply bring it to the board, which gives you a binding decision.

B. Desirability of Permitting Corporations to Opt Out of Liability Rules

1. *In General*

DEMSETZ: Why not let these firms arrange their own affairs as they please in the absence of some kind of demonstrable externality effect? I would think that's where the issue would be joined.

SCHWARTZ: It's not exactly as if a choice were then to be left to some objective scientist who will experiment and choose something that might be successful, or which might not, but in any event based upon a desire to improve the welfare of the corporation.

The choice that is made for corporations is made by the managers themselves, the ones who are vulnerable to litigation. The choice is a self-interested choice. The choice among the states is, again, not a choice made by informed legislators after a process that we are familiar with. You've got state legislation in this area that is unaccompanied by public hearings, by any kind of a record, or by any kind of committee reports. Local bar associations for the most part write the corporate laws of most states. Those state bar associations follow the lead of corporate law committees which are committees composed of lawyers who represent people who are going to be affected by these rules.

Moreover, the differences from one state to another in this area are not very significant. What Delaware decides is essentially followed by courts in other jurisdictions because they don't have the litigation experience that Delaware has, so that there isn't the kind of free interplay in a market place that's been sort of romantically described.

FISCHEL: You think, apparently, and the drafters of the ALI think, at least implicitly, that these choices about contractual form, which you refer to as self-interested, are therefore suspect. There are two important responses to that.

First, there is a lot of economic theory and evidence relating to one very simple insight: No matter how self-interested managers are, investment is still voluntary. The investment market is one of the most competitive markets there is. It is very, very difficult for managers to make what you refer to as self-interested choices in organizational forms in a way that operates to shareholders' detriment because shareholders have an infinite number of alternative investment opportunities. In fact, we see things like firms voluntarily subjecting themselves to independent accountants, the evolution of independent directors, resort to capital markets, and all kinds of voluntary monitoring devices. It's no answer, if you see a situation where firms do not voluntarily subject themselves to something, to say that that's self-interested. It's just as plausible, if not more plausible, to reach the opposite conclusion—that they don't subject themselves to it because investors don't value it.

Second, there is a kind of nirvana fallacy in the argument that manager's decisions are self-interested, therefore they should not be respected. The question is, whose decision should be respected? In this context, as well as all other areas of the ALI project, the choice is between managers who are disciplined by a variety of different markets in situations where there is no problem that's been demonstrated, versus a group of, primarily, law professors who want to substitute their judgment for the judgment of the managers who are disciplined by markets and say that because the management's incentives are not perfect, because they are self-interested, that means that the law professor's judgment is better. That doesn't follow.

DEMSETZ: I'd like to respond to the point that was raised by Don Schwartz with regard to choice being dominated by management on these issues. I'm sure this is an important point. I'm not quite clear as to what the truth is on this score. Ken Lehn and I have just done a paper which will appear shortly in the *Journal of Political Economy* in which we find for 511 Fortune 500 size firms that the five largest shareholding interests, on the average, own about twenty-six percent of the shares of the companies. This is hardly a picture of the "diffuse" shareholder not able to attend to his interest. I think there is considerable evidence, in fact, that choice will not be dominated by management, even in very large corporations. We find also that variations in the concentration of ownership of corporations follow what we considered to be sensible, economic dictates in the market-place, so this is not just some random ownership structure but one that changes from firm to firm depending upon conditions under which the firm operates. So there is more evidence that there is a market determined control mechanism in operation here than we would infer from merely looking at the market for takeovers. This has nothing to do with takeovers, actually.

WEISS: I don't know that courts or legislatures have ever viewed corporate relationships as purely contractual. I don't think that many people view corporate law as involving purely contractual values. I think there are many people in this society who view corporations as social and political as well as economic institutions and are therefore concerned about the social and political impact of even internal governance rules of corporate law, insofar as they have some impact on corporations' economic, social and political behavior.

LEUBSDORF: I'd like to expand on some of Elliott Weiss's comments. It seems to me that an important value here is legitimacy of the corporate government. Of course, the government has an important interest in preserving its own legitimacy. For instance, problems of theft are not confined to directors and managers—they could occur throughout the corporation. It's equally clear that you can't prevent them simply by going around and threatening to impose sanctions. You need to have some basic atmosphere of reliability and responsibility among all the employees of the corporation. How are you going to have that if it becomes clear that the managers have a considerable ability to enter into self-dealing transactions without any legal consequence? A self-interested shareholder would want to preserve some check, even if it was very rarely used, simply to preserve the morale of the corporation as a whole.

But I think it really goes beyond that. Corporate officers are exercising a lot of power, making important decisions, and they should be responsible in some way to the people, to their various constituencies. Government officials can be brought into court in all sorts of ways to have their decisions challenged. It's true that to hold them financially liable is rather difficult. You usually wind up simply with a court judgment about the legality of the act with an injunction requiring different behavior in the future. But I think that the public is going to insist on some kind of remedy, at least in our society. There may be other societies in which it is accepted that someone who is in power is probably acting for the best and no one thinks of saying you have to have a court remedy. But I think ours is different, and that leads me to predict that if you were to limit derivative suits, probably you would find the law governing other remedies expanding. Shareholders, or other people perhaps, would simply be bringing suits that did not go through the corporation.

SCHWARTZ: Bill Carney talked about the contracting out in tax shelters. That's a particularly interesting illustration because a real bargain is struck in those situations. In order to attract investors into a tax shelter deal, the promoters say we're going to run this thing and we are going to advise it and we are going to be charging fees for everything we do. There are conflicts between your interest and ours in some respect. However, the trade-off is we'll give you ninety-nine percent of the tax benefit. What I hear proposed is that for nothing particular in return managers should now contract out of liability rules. I'm not sure what the quid pro quo is in that bargain, but in the one Bill described certainly there is a quid pro quo.

CARNEY: The quid pro quo when managers contract out of liability is a stock price adjustment. If managers contract out of too much liability from an efficiency perspective, stock prices will drop. If managers are contracting out of the optimal amount of liability, whatever that is, stock prices should rise. I expect efficient markets to make the adjustments over time to reflect that. As long as managers' wealth is invested to a substantial extent in the shares of stock of the company, managers will pay a price for contracting out if they contract out excessively.

GOETZ: I wanted to pick up on Weiss's comment on corporate law being designed to achieve policies other than the interests of the parties concerned. I think too much can be made of that distinction because one can really say the same thing about almost every compartment of law, including contract law. There are, after all, contracts that we don't allow people to make as contrary to public policy. We regnlate private transactions in various ways. There is no reason why we shouldn't do the same thing with corporate law. But in contract law there is at least a prima facie case to let the parties do what they want. Then, if one can identify some third party with societal interest to counterpose to that, you can rebut the prima facie case. I think that the suggestion has just been made here that the same thing is being done.

Bob Scott and I have recently written on the difficulties of opting out. There is always an advantage to the standard form contract, whatever it is. There is always a certain security in the status quo.

Parties can never be quite sure that the courts will enforce an unconventional agreement. But even if one thinks that the courts will enforce it, there is some uncertainty as to how a nonstandard contract will be construed. Particularly in complex areas, parties may strive to write language that governs their relationship in a particular way, but until the language has been tested in the courts, parties don't know really what their agreement means. Such contracts are not really reliable.

The third thing which cuts contrary to taking a contractarian free market approach is recognizing differences in market behavior. There is a terrible free rider problem in the processing of information with respect to group choices. For an individual's own private purchases, he bears all the consequences. By contrast, the Public Choice literature explains why rational persons will not be as well informed with respect to political decisions. Agreeing to an opting out or a change in the corporate charter fits the political model. There are, therefore, potential informational benefits from some kind of standardization and limiting of the number of options.

Thus, the ALI need not allow parties to do absolutely anything under the sun. It can create a limited menu of standard form contracts that embody divergent philosophies. Then, over the course of time, people would become familiar with the language of those alternative forms of agreement. Allen Schwartz has written in the contract area pointing out similar advantages in standardization of warranty forms. People can then evaluate the alternatives more securely in a world of costly information where we must confess that a lot of people are ill-informed.

WEISS: I wasn't arguing that corporations ought to be viewed as primarily social or primarily political, but even if one accepts the premise that they are primarily economic insitutions, there is a lot of room for dispute about when—and on the basis of what other facts, values, or institutions—we ought to allow noneconomic values to intrude or carry weight when we are setting the ground rules.

I had some experience with institutional investors and their voting on matters that were probably of only trivial economic importance—shareholder proposals—largely relating to social issues. Even though these matters were often of no great importance, the investors often were subjected to significant pressures, by people with whom they did business, concerning their voting decisions. This experience suggests to me that we should not be too confident that institutional investors, when they are making proxy voting decisions about matters concerning which there is debate and uncertainty, are always motivated to make sure that their votes will maximize the return on their investments. I think those decisions probably reflect a balance among a number of pressures, and I'm not sure how the institutions draw that balance. If anybody has any specific data about that process, I'd be glad to hear about it, but in the absence of data, I remain skeptical.

FISCHEL: I was intrigued by what Charlie said about having a limited menu of standard form contracts. I've thought about that issue a lot, particularly in connection with the mandatory disclosure system. I never know how to interpret that kind of argument. Is it different from saying that we should only allow a limited number of different ways to make widgets, for example? Corporate decisions involve presumptively higher information costs than consumers face. There really seems to be some trade-off between innovation and information costs.

With respect to some of the comments about the other values that have to be taken into account, the stated purpose of derivative suits generally is to make shareholders better off. So if you say there is no evidence that it makes shareholders better off, then the response is, well, maybe it makes somebody else better off. The problem of making somebody else better off is that it makes shareholders worse off. It becomes a completely amorphous, nontestable, theoretically inconsistent kind of a position. So at least as long as the derivative suit, unlike, for example, the criminal law, is defined as a monitoring mechanism for the benefit of investors, I think it is better to talk about it in those terms.

MACEY: Even if we don't care about benefiting shareholders, and we want to promote other values, societal values, it still leaves open the question of why either derivative suits or class action suits are the proper vehicle for championing these other values given the fact that I think every one recoguizes the kinds of strategic behavior that can be associated with these activities. It seems to me that some kind of constitutional or democratic process is the appropriate vehicle for that kind of legislation rather than some sort of ad hoc litigation idea.

WOLFSON: There are scores of suits out there in the country, and judges are making decisions as to the scope of opt out provisions under state law or even under the Securities Act of '33. For example, insurance has a wider scope of protection of the fiduciary than does indemnification. Does the Fischel-Bradley paper direct the judge to move in one direction or the other?

FISCHEL: The paper is really not specifically addressed to that kind of question. If it's really a contractual provision that's in the charter, I would say what I would say to all questions like that: Absent demonstrable third party effects, I would enforce whatever the agreement is.

WOLFSON: Let me pursue this just one second further. The judge might ask you, "Look, if in fact, liability provisions have a fruitful impact on directoral behavior, which is really a layman's description of what we're talking about on opt out, then that will impact me in my mix of policy making and decision as I reach my result. Do you have any recommendation to make?" In other words, if liability rules have little or no impact on directoral behavior because of the other alternatives, the judge might reach one conclusion. If the mix of liability rules will have a significant effect on directoral behavior, then the judge might reach a different conclusion.

FISCHEL: I would say, "You, Judge, are not in the business of rewriting contracts for the parties." That question is no different than, let's say, a contract between two people to build widgets a certain way, and somebody sues for breach, saying they should have been built a different way.

WOLFSON: I don't think we have sufficiently paid attention in our analysis to what I believe is the fundamental vagueness of the loyalty doctrine. The longer I look at it, the more I study it, and the more I teach it, I find myself increasingly unable to articulate the doctrine, other than to repeat the word that you see in so many cases, fairness. It seems to me for that reason, and for others, that there is a real need to increase the ability to opt out or apply some kind of informed consent doctrine for stockholders, in which they could be given a menu and the corporation could say "I choose to be under the regulations of the 1933 Act, or I choose to be under the regulations of the Investment Company Act of 1940, or under this incredibly vague doctrine called duty of loyalty, hence, buy my stock, don't buy the stock of my competitor in the steel industry who by charter provision has opted out of those provisions." It would seem to me an appropriate approach to take. I would recommend such an opt out provision, which would come close to eliminating reliance on duty of loyalty and reliance on many other statutory protective provisions.

CARNEY: One of the problems that I have when we come to the discussion of the duty of loyalty, is that I think the area includes two kinds of cases. One is cases involving managers and their fairly straightforward dealings with their own firm. The other set of cases usually involve some conflicts of a majority stockholder that caused the firm to do something, usually merge or sell its assets to the dominant stockholder. I have a lot of trouble lumping many of those cases in with this discussion. They tend to get lumped in with this discussion either because the directors, who are agents of the majority stockholder, are seen as breaching a duty when, in fact, what's going on is that a person who holds the votes has caused a transaction to happen. Those are really ex post disputes about the division of the proceeds of the transaction between the majority and the minority. They tend to get treated under this vague fairness rubric that Nick Wolfson has referred to. Those cases don't belong under the discussion of duty of loyalty at all. I think that when you take them out, you will find that what's left, in many cases, is fairly trivial in terms of investor interest. The amount that managers are stealing, if that's the appropriate word to use, is so minor that there is not really much to talk about.

2. *Opting Out Through Independent Directors*

WEISS: With respect to opting out through internal and external monitors, it seems to me, first of all, if we look at external monitors, particularly accountants, there are fairly detailed performance standards, GAAS and GAAP, and we have increasingly stringent liability rules.

When we look at the internal monitors, particularly disinterested directors, which is the way it is usually defined, the courts don't make determinations about whether people are independent, in the sense that one usually means when using that term, but about whether the directors in question are disinterested in terms of having no pecuniary interest in a transaction or no subordinate relationship to the people making or benefiting from a decision. There also are very few specific standards, analogous to GAAS or GAAP, concerning what those directors are supposed to be doing. The liability threat is almost nonexistent with respect to directors when performing a monitoring function, so long as they do something. The courts usually fall back on the rationale that, after all, these are the people who have been elected by the shareholders. It seems to me that this really is not a very convincing argument, at least in corporations with diffuse share ownership. The directors, by and large, are selected by management and serve at the invitation of management.

A really central issue raised by the ALI project about liability rules is: to what extent should a corporation be allowed to opt out of substantive judicial review of transactions by having these directors review it? I believe the ALI project should very much limit this sort of opting out, at least where the "independent" directors are passing on what we traditionally class as duty of loyalty transactions, and where they are being asked then to pass on the merits of litigation alleging breaches of the duty of loyalty. In all those situations, the lack of standards, the lack of liability threats, and the possibility of manipulation reduce very much our degree of confidence that these people will be effective monitors. Therefore, dispositive weight should not be attached to their decisions.

FISCHEL: In response to what Elliott said, the question is a relative one of benefits of different systems, all of which have certain imperfections attached to them. Just as it does not follow that you should never have liability rules because some judges are appointed for political reasons rather than on merit, nor does it follow that you should not give deference to decisions by directors because they are not perfectly independent. It's not in the interest of the firm to structure a set of contracts in a way that monitoring proceedings are a sham. That would be costly, and they have no incentive to do that, just like they have no incentive, at least ex ante, to pick an accounting firm that's not really going to provide independent monitoring. To the extent that monitoring is valuable, the firm will pay a price in the market for doing that.

3. *The Problem of One-Shot Expropriation*

SCOTT: The issue of "why not go for an optional structure" is not a bad way of focusing the discussion. As I indicated in my comments in my paper, the long run arguments that can be made for that kind of a regime, I think, are fairly compelling. The main thing that troubles me is the short run or transitional aspects of that kind of a change in our legal structure. That gets you into this question as to the already existing firm where you have a large shareholder base and investment in reliance upon a set of mandatory rules that impose some constraints, although the definition of those constraints is somewhat fuzzy, as we've been developing. To what extent is there an opportunity for one shot expropriation by incumbent controllers of the firm?

PASHIGIAN: These would have to be voted in to the charter, so it's not a question of management announcing on their own that this is going to be the procedure for this corporation. It seems to me that this at least partially, perhaps fully, addresses the short run problem. They could not in the short run abscond with the assets and expropriate the shareholders, without their consent at least.

SCOTT: In a draft paper by Vic Brudney that I was looking at earlier this week, he goes on at length to make the counter argument that the contract paradigm is not appropriate, that the notion of one-on-one bargaining by informed principals, acting volitionally, does not describe adequately the corporate shareholder voting context for the large corporation with the information cost and free rider problems associated with it. That would permit, therefore, a degree of expropriation by incumbent controllers.

I don't think that is wholly imaginary. One study that I've been meaning to do is to look at transactions proposed to shareholder vote in which the initial market reaction was a negative abnormal return of some non-trivial order of magnitude, greater than 1%, and look at the shareholder vote where the market reaction to the transaction was a negative evaluation, where you had a management recommendation for the transaction.

I have observed a number of instances, but I don't know how large a section of the whole they are, in which those kinds of negative transactions, endorsed by management, were in fact ratified by shareholders. It's that same kind of phenomenon that might apply here to the question of a proposal to move from mandatory structure to some kind of optional structure. Would there be a significant expropriation cost with that? If it were significant, it would be politically very damaging to the cause of optional liability rules because it would undermine the case for the long rnn benefits of it.

SCHWARTZ: I wonder if we haven't seen examples of exactly what Ken described with respect to shark repellent provisions that a number of companies have adopted. Those are the anti-takeover charter provisions that have made it more difficult for companies to be taken over. As I understand it, the studies that Gregg Jarrell and others have done show that there have been nontrivial adverse reactions to the adoption of those proposals. Here we have seen management motivated by a serious conflict of interest, protecting their own employment against the possibility of a takeover, plunging ahead with proposals to shareholders which, for the most part, they have ratified notwithstanding the heavy incidence of informed institutional investors who do not find it in their interest to have these anti-takeover provisions. Isn't that a case that would trouble those who favor a contractual basis of limiting exposure in liabilities?

LEFTWICH: In reference to what Don Schwartz referred to as the shark repellent evidence, the best published evidence is unable to find a stock price effect of those amendments. The SEC study that has Gregg Jarrell's name associated with it but perhaps not his authorship finds a negative price effect, but no statistician would say that it was reliably different from zero. The reports of it in the press have exaggerated those or picked up on the negative price. People for various political reasons have adopted one view or the other on that. I wouldn't necessarily defend those studies. They have problems similar to those that Mike and Dan have as to how you interpret the evidence. But the academic research suggests that those price effects have not been detected if they are there.

DEMSETZ: My comment is in response to Ken Scott's proposed study. I think, first of all, that it's difficult to know what the world is going be to like if we went to the optional system that Peter is suggesting. For example, corporations, on the average, would tend to become more tightly controlled in the optional system. I probably count that as a good effect. Secondly, I hope you do the other half of the study; when courts decide on issues bearing on shareholder interest, look at the behavior of the price of the stock after the court's decision and make a comparison between that and the voting decisions that you want to look at.

CARNEY: I know of three stock price studies that have been done with respect to adoption of shark repellent amendments. One says no significant effects at all, one says maybe some positive effects and the other says maybe some negative effects. Richard was telling me that the last one doesn't have any statistical significance. I'm kind of disappointed in the economists, that we haven't been able to come up with any real answers with all these event studies.

I think I know at least part of the reason why. I don't think they've yet reached the point where they are asking the right questions. When shark repellents are proposed, they are a complex mix of voting rules, price rules, and a variety of options available to stockholders and boards. Nobody yet has tried to sort out all the complications of these amendments to test for price effects with various voting rules, fair price rules, and that sort of thing.

At best, we get a separation of voting rules and fair price rules, which I think is what Jarrell tried to do. At this point, I think the economists need to talk to the lawyers before they do any more of those studies. I suspect the same may be true in other areas, that we need more communication with each other about the variations that are taking place in the real world, so that we can test for things that are really happening instead of lumping them all together.

GOETZ: To call this a bargaining process may not be correct because of informational difficulties or because it is, after all, a voting process with less than an absolute unanimity of acquiescence by the affected parties. Ken Scott's problem is one that I agree with. When the rules change, there is a possibility of exploitation. I'd just like to recall the literature applied for many years to Public Choice questions. Our fellow discussant Gordon Tullock is the co-author of one of the best, seminal books on this, dealing with constitutional rules and changing the nature of the social contract. One can view the corporate contract in much the same way and at least raise the question whether shark repellent and poison pills are equivalent to changing the social contract or changing the constitutional rules. If so, perhaps they should require special decision-making procedures. A lot has been written justifying two-thirds majorities, three-quarters majorities, perhaps not allowing proxies when rule changes are effected. There is also reference in that literature to what Bill referred to a few minutes ago as mixing up things, like voting rules and prices, where suggestions for alterations are bundled together. There is literature on log rolling, how one can tell when issue packages are stuck together by people, what the implications of their being accepted or rejected really are. The literature also analyzes the power that someone has who controls the components of the bundle, the agenda that is being voted upon.

MACEY: Given the fact that firms are subject to market constraints that governments aren't, I'm not sure, Charlie, how effective it is to transpose public choice literature onto corporate governance. I'm not sure, but I'm prepared to be educated.

GOETZ: Jon, perhaps you are thinking of public choice models of one big government with no other options. But certainly Tiebout and others have discussed the phenomenon of people moving from local government to local government, or from state to state or city to city, so that there are market constraints in essence on governments as well, as long as people have options as to which government they belong to.

TULLOCK: The existence of the market mechanism means that you don't have to worry nearly as much about the voting procedure, but it doesn't mean that rules are worthless.

LEFTWICH: When you start talking about changing the rules of the game in the middle of the game, you are going to impose some costs on some parties. The ALI proposals if adopted would change the rules of the game in the middle of the game. They would hurt some parties and benefit some others. That's a very different issue from saying, what if you were allowed to bring a company to market with these rules in its charter? One transition arrangement might be to allow a new product, such as a new contract, to come to market without forcing everyone to have the same contract. It's quite often the case, when the NYSE changes some of its requirements, that new issues brought to the floor are allowed to have these provisions, but existing issues are restricted as to the provisions they already contain. I think that distinction is worth maintaining in the sense that you get a little bit away from this one-shot expropriation.

GOETZ: I don't think you can do what Richard suggested and allow new rules to apply only to new contracts. Thus, only new corporations would be allowed carte blanche in their charters. It's a tempting suggestion unless one raises the question of the survival characteristics, under those circumstances, of the existing corporations. Suppose the new rules really are more efficient and they provide advantages in the market-place. Are we really going to say to the stockholders in existing corporations that there will be no transitional mechanism so that they can take advantage of the same more efficient rules?

PASHIGIAN: When is allowing contracting out tempered by some concern that there will be an opportunity to exploit at least a minority interest in a corporation? I think that we just don't know at the moment how easy such exploitation is, nor do we know how easy it is to prevent it.

It might be useful to be thinking in terms of a more historical perspective as to what kind of investors were in the market in the twenties and what kind of investors are in the market today. My casual impression is that in some ways we have more protection today than we did in the twenties. I'm inclined to believe that we might see more roundlot purchases. We clearly have the opportunity to use all sorts of mutual funds today in making our purchases, and we rely on agents to make investments for us. It's not clear to me that, if you went back into the twenties, investors had those options. To the extent that one could demonstrate this kind of long-term shift it seems to me that one's concern about investor protection should diminish rather than increase. Therefore, the justification for imposing uniform liability rules is weakened to the extent that trend has occurred.

ALCHIAN: What's disturbing is our inclination to sit here and state what is to be done in the world without any evidence. We have got our personal impressions about whether outside management is doing a good job or not, but you can't make policy, I hope, on that kind of a premise. You've got to have some facts to support your proposition. Illustrations don't work. For example, some of these shark repellents have been damaging. Managers are not perfectly foresighted. They make mistakes. Stocks go down. You've got to give me systematic evidence that they are doing this against stockholders' interests, and we don't have it.

The stock corporation has been around for several hundred years. It's been evolving over those years. What would you have said back in 1500 about limited liability? Good idea or bad idea? What I see here is, "Aw, it would be a terrible idea!" Yet it evolved. I'm disturbed that we sit around here trying to make policy recommendations without having any good analysis about what is going on. That's true of the lawyers and that's true of the economists, but at least we try to get some evidence. It's just disturbing.

IV
The ALI Project In General

A. Effect of Project

DEMSETZ: When the ALI finishes its craftsmanship and the members of the organization approve it, what does that mean? What happens as a result of that? This certainly doesn't make it law. Would somebody please inform me?

DOOLEY: This is only a partial response. Historically, the American Law Institute projects have been quite influential in the courts. What makes this doubly significant, I think, is that there is the same kind of time-bomb lurking in § 8.30 of the *Revised Model Business Corporation Act*. That will have real consequences if § 8.30 is enacted as it presently stands because before revision, the Model Act accounted for about half the corporate laws in the United States.

MANNE: The somewhat peculiar structure of the ALI corporate governance proposal also makes it more likely to be used as a model for state legislation, so it may have a reach beyond its usual influence on courts.

SCHWARTZ: When the ALI votes on this thing and it becomes an adopted document of the American Law Institute, it becomes quotable authority. It doesn't become law. It becomes an authoritative statement by a recognized private association that tries to concern itself with accurately stating and improving the law.

Let me give you an example: § 7.08 is a provision that we'll probably talk about because that deals with the ability of the corporation to set up a special litigation committee to terminate derivative suits. In the official comment, it says as to implementation,

> "§ 7.08 could be implemented by judicial decision except in the very few jurisdictions that have already adopted a statute gov-

> erning this area in which case legislative action would be necessary."

What they are saying to a court is that you can use this as a model, this is the American Law Institute's statement of what the law ought to be. Traditionally, as Mike points out, ALI documents, which usually have been called *Restatements*, have been influential in terms of what judges do.

MACEY: Concerning how much influence this project might have once it's adopted, it does differ from most ALI projects in the sense that typically these projects have been *Restatements*, attempts to simply rearticulate the law, rather than to come up with novel legal premises or legal rules. This project is also different from typical ALI projects in terms of the degree of controversy that surrounds it. I tend to think that many of the provisions have been sufficiently discredited that many judges will refuse to give this project the deference usually accorded ALI projects.

B. Change by Evolution or Decree

GOETZ: Given the deference which judges sometimes give to ALI pronouncements, if there are a number of solutions which seem to be reasonable solutions and in the ball park, why does a single best one have to be adopted at all? If there are alternative institutions which are defensible, then perhaps one should say so. By admitting that we are incapable of picking with great security among those institutions, we would leave the question open and allow experimentation that might reveal to us what really does work.

FISCHEL: Given the uncertainties in this area and the point that there is no reason to believe that every firm will have identical monitoring structures—that firms with, for example, highly concentrated stock ownership might value something like derivative suits less than firms with weaker internal monitoring devices—we don't see any need to choose between one kind of rule over another kind of rnle. We would be much more content with the normal evolutionary process of contractual development within firms and competition between states. In fact, one of our fundamental critiques of the ALI project, not just in this area but in other areas, is the need to choose between alternative rules or alternative contractual strnctures when given the state of the evidence, it doesn't appear that there is any problem that needs to be addressed in this area and others, and to the extent that there is, there is no reason to believe that all firms would resolve it in the same way.

WOLFSON: Each of the decisions concerning derivative suits, whether we should have a one-step process or a two-step process, and then whether demand should be viewed more or less carefully, and all the host of other small decisions we're talking about, is obviously based upon sheer hunch at best. The ALI is making these decisions purely on hunch. Therefore, these are essentially political decisions. I know that the courts are making these decisions all the time, but at least there's some difference of viewpoints among courts in different jurisdictions, so there's some form of experimentation.

There are two modes going on. The lawyer qua litigator is doing what has to be done out there. There he is, in a form of combat or whatever. He has to do what he has to do. What he does is genuine in that sense. The lawyer qua scholar in these ALI type functions is engaging in a form of subterfuge. What he really should be saying in each of the subsections of the ALI is, "We herewith toss a coin, or we did it by trial by combat, or the stronger group prevailed by arm-wrestling, hence we reached that conclusion."

V
Fine-Tuning the Derivative Suit: Specific Rules and Proposals for Reform

A. Compensation of Plaintiff's Counsel

MANNE: One of the central questions in this whole subject is the implications of the system for attorneys' compensation. That may be, after all, the small bit of fuel that's driving a very large vehicle.

SCHWARTZ: Up until maybe a dozen years ago, the attorney fee, which is in all cases determined finally by the court, was fixed on a theory known as the "salvage value" theory. That is, the attorneys' compensation was based on a percentage of the recovery. About 1974 or so, a number of courts started adopting a different mode of compensation known as the "lodestar" fee. Under this approach, lawyers were paid as they would be in other contexts, based on the value of their time, subject to adjustments. If it was an especially difficult case, or an easy case, you might make adjustments from their ordinary fee. This rule makes settlement at an early stage in the litigation nearly impossible. You have got to let the thing get strung out so that the time can be expended.

I also think that there ought to be a means of reducing the temptation to file suits that are likely to be frivolous. Or, putting it another way, plaintiff's counsel should be required to undertake a pretty serious analysis so that suits that they are likely to bring are those that have a high promise of being successful—in other words, to go after the suits where there is really a problem and not just to file suits that have largely nuisance value. One way of dealing with that is to readdress the problem of how we compensate plaintiff's lawyers.

I think we should probably return to what had been the prevailing system of allowing plaintiff's lawyers to recover only when they were successful on the part of their client, the corporation, rather than on the basis of time.

SCOTT: There is no obviously perfect solution to the attorneys' fee issue, because it's a principal-agent problem and there is no perfect incentive structure. There are degrees of imperfection. I would assume that the worst is to have an arrangement that does not in any way relate the attorney's compensation to the success and the recovery in the lawsuit, or in the settlement. You have to have some mechanism, therefore, for tying this reward to the value of the lawsuit as measured by the recovery. If it is not a damage lawsuit, if you are seeking injunctive relief, or something like that, then the problem really gets difficult to measure and administer.

On the other hand, I don't really see why any of these problems are any different in an important respect from other species of contingent fee litigation. A nonmeritorious lawsuit is a waste of time. Unless you are a very unemployed lawyer with no competing alternatives, you want to bring causes of actions that have better chances of success and higher expected values.

DOOLEY: Ken suggests that the agency problems involved in the derivative suit plaintiff and the derivative suit lawyer's case are no more exaggerated than they are in other instances of contingent fee litigation. There is one very peculiar aspect to the payment of lawyers' fees in derivative suit cases that does exacerbate the agency cost problem. That is, uniquely here, the lawyer can fail to recover any monetary benefit for the corporation or ostensible plaintiff's class at all but nonetheless be held to have conferred an intangible substantial benefit on the corporation. You may recall from the *Mills*[7] case, which was decided under the proxy rules, that by pointing out a trivial error in the proxy statement in connection with the merger, which everyone agreed was fair, the lawyers were able to collect hundreds of thousands of dollars in fees. This really exacerbates the conflict of interest problem. You may have an incentive to bring the typical strike suit because even if you are not successful, you may be able to get the managers to agree to the identification of some substantial benefit. The other way it cuts, of course, is that you may sacrifice the interest of your plaintiff in order to cut down

7 Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

on the amount of their recovery, but you still get yourself a very substantial benefit. To give one very dramatic example of the difference a derivative suit makes, in an injunctive action, even if it's brought on behalf of a class of plaintiffs, there is no provision for the collection of attorney's fees from the benefited class if you have no pre-agreement with them that they are going to pay you. All you need to do is to characterize those same operative facts as a proxy rule violation, turn it into a derivative suit, and you will end up getting the fees paid for by the corporation.

LEUBSDORF: I don't think it's appropriate to say that we should go back to the old percentage system, because there was no old percentage system. There were a few decisions which said judges have to pick a percentage. There were some articles, notably by Professor Hornstein, approving this, but there was no agreement whatsoever as to what the percentage was supposed to be. So that it doesn't seem to me that you have any system there: Each judge was able to pick whatever percentage seemed appropriate in each case. I find it hard to see in that any kind of guidance to plaintiffs' lawyers as to which cases they should accept, or any kind of social judgment as to which cases are to be encouraged.

Is there any reason to adopt a pure lodestar approach which might lead to a fee substantially larger than what the corporation recovers? That implies a social judgment that you want derivative suits to be brought even if the corporation itself does not benefit in the short-run. You might want to adopt such a theory if you have a strong belief in the deterrent impact of such suits on other cases. A percentage approach, on the other hand, tends to aligu the interests of the plaintiff's lawyer with the corporation's own short-term interests. You might want to have some kind of combination of percentage and hourly rate. It requires a fair amount of detailed analysis to figure out what the implications are for each formula as to what kind of suits you've decided to encourage and why. No one has really done that yet.

If you are going to have a system, that requires something else, too, and that is some method of making sure the fees actually paid have some connection to the formula which you've established. The basic problem that we start out from is that most of these cases are settled, so that the parties and not the court may fix the fee.

FISCHEL: The more basic question which I think needs to be addressed before you can get to fees is, again, what is the marginal contribution of these private attorneys general. We need a theory for why it is these people are needed as opposed to large shareholders. Why do you want to create any fees to compensate people for additional monitoring? Large shareholders have the same or greater ability to bring the suit and the collective action problems are, at the very least, significantly minimized. The whole premise upon which all of these fee discussions rest, namely that there is some need to give these people incentives to bring suits, is a very questionable proposition.

MANNE: Ken Scott once slyly recommended that we might just do away with the requirement of having shareholder plaintiffs in these cases altogether and let attorneys simply be designated as private attorneys general. This idea seems to raise the problems of the derivative suit in its darkest form. Nobody in the ALI would buy that notion. The Business Roundtable would spend $10 billion lobbying against allowing the organized bar of the United States to have carte blanche to bring these suits. Yet I think we could probably all agree that that is almost exactly what we have today, except that the present scheme is a little more expensive. Let's assume the simple rule of always allowing the attorney who is first to discover the cause of action to proceed. Now what really is the difference between that and what we are doing today, other than that it's cheaper? The fees would still be set in precisely the same way. The corporation would get precisely what it does today. We should note, however, that the lack of the opportunity to impose a contemporaneous ownership rule under Ken's proposal would distingnish it significantly and argue against allowing a full-fledged version of the private suits by lawyers.

DOOLEY: Another reason your proposal would be so controversial is very easy to understand, although the economists are going to have a little difficulty with this: We lawyers despise bounty hunters as much as we admire private attorneys general.

B. Barriers to Suit

1. *Contemporaneous Ownership Rule*

SCHWARTZ: The current ALI approach to contemporaneous ownership says that a holder of an equity security, which is defined as either being common stock or a security convertible into stock, (convertible debenture holders can be plaintiffs) has standing to commence and maintain a derivative suit if the holder "acquired his equity security before the earlier of the time the material facts relating to the alleged wrong were publicly disclosed or were known by the holder"[8] and he continued to own the stock at the time of the

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8 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.02 (Discussion Draft No. I, 1985).

suit. The theory is that you are not supposed to be able to buy a lawsuit. Ownership may occur later than the event of which you complain. If we are talking about the true surreptitious self-dealing transaction that has never been disclosed publicly and is not known by the plaintiff, the plaintiff could bring suit even if he bought shares at a later date. Clearly, he did not buy stock so he could bring a lawsuit. That is consistent with the rule in Pennsylvania and California, but it is not the rule anywhere else.

SCOTT: It's the victim compensation point. If you are concerned with compensating injured parties and you see some injured parties, then the contemporaneous stockholder rule plays a purported function in compensating only injured victims. If you're concerned with deterrence, you're not concerned with who gets the compensation; you're concerned with the proper incentive to maintain the lawsuit.

2. *Security for Expenses*

SCHWARTZ: The security for expenses is trivial. It was a device invented in New York in 1940-42 to check the number of stockholders' derivative suits. Under the law in New York, which provided the model for this, if the suit was filed by a person who owned less than five percent of the stock of the company, he could be ordered to post a bond as security for expenses of the defendants. The bond would be in an amount determined by the court. It would be expensive to furnish the bond, but, worse, you might have to actually pay on it. That mode of statute was followed by several other states. New Jersey had it, California had a variation of it. It was widespread. It was predicted by one legal scholar as the deathknell of the stockholder derivative suit. Like Mark Twain's obituary, this one was quite premature for several reasons. One is that many suits were filed as violations of the federal securities laws along with a state law count. One could not impose the security for expense requirement on suits filed under the federal securities laws. The other thing is you would ask the company for a stockholders list and then try to solicit other persons to join you with the suit to get up above the five percent level. In practice, it has not been a significant device. One measure of its significance is Delaware never adopted any such requirement for suits filed in a Delaware court. The *Model Business Corporation Act* recently, in its 1984 revision of the statute, abandoned the requirement of security for expenses. I think at this point it has become an unimportant requirement.

MACEY: My response to what Don just said is that while I agree with his use of the adjective "trivial," I'm not sure that that is always the same thing as "uninteresting." What's interesting about security for expense statutes is their attempt to impose a nontrivial roadblock on the initiation of derivative suits. This is interesting in spite of the fact that, ultimately, the roadblock was successfully circumvented and did become trivial.

MANNE: If it really were trivial, I'm not so sure that much energy would have been spent on reversing it. I think it did have an effect, and it was there for a very important reason. There is a much higher likelihood of so called "strike suits" from small shareholders, who can't suffer much of the cost but who may experience a lot of the gain, than from a holder of a large number of shares. The approach is perfectly sensible, and to get around it costs money. It is not costless to find a nominal plaintiff, and it is not costless if you preferred being in state court without a federal count. I think the principle underlying it was perfectly correct. Now, I don't know whether it is trivial or not, but I don't think you do either.

SCHWARTZ: There was one study of it made in 1968 in a journal published by Columbia Law School, after a twenty-three year experience, that indicated that it had not had the intended effect.

SCOTT: The bond aspect was not all that important, but the different rule that losing plaintiffs paid the defendants' legal fees does, indeed, change the incentives of plaintiffs' attorneys. The problem with saying that the bond is the correct principle is that it changes the incentives for plaintiffs' attorney without any dependence or reference whatever to the merits of the lawsuit.

MANNE: No, that is not true. Statistically it must be true that a higher percentage of cases brought by large shareholders will be sustained on the merits than those brought by small shareholders.

FISCHEL: Shareholdings are not immutuable. If you believed in the entrepreneurial theory of the plaintiff's attorney, they could act very much like control bearers and aggregate shares if they really felt they could increase the value of the firm by their actions.

SCOTT: That would make a difference in New York, for example, but not under the California rule, which does not turn on the size of the plaintiff's shareholding.

FISCHEL: The point is that if, as suspected, at least in publicly held corporations, there is an inverse correlation between size of shareholdings and who the plaintiff is, then I think that that is very valuable information as to the value of these types of suits. The issue is getting people to bring suit who have the right incentives or better incentives. In that sense, I think rather than dispensing with some of these requirements, you can make a good argument for strengthening them—making it harder to get around the security for expense statute for example. The initial purpose of the security for expense statute seems to me to be a very sensible one.

SCOTT: Yes, but you can't keep entangling two subjects and clearly analyze either of them. There are incentives, and there are reasons to think about the way our litigation system works in general. The loser-pays-expenses rule is a thing to think about in the operation of our legal system in general. Those issues do not pertain solely to the stockholder derivative suit or the issue of corporate liability rules. If you want to deal with the functioning or malfunctioning of the litigation system in general, that's a perfectly appropriate topic, but it is extraneous to a consideration of the function of liability rules in the relationship between the shareholder and the management.

FISCHEL: I do think there is a difference, but I don't think that they are unrelated the way you have said. The point that we make in our paper is that there are worse incentives on which to sue when you are a small shareholder of a large corporation than there are in other litigation contexts, particularly when the beneficiaries of the suit are other shareholders who frequently will have a larger stake in the venture. Because the ability of somebody with a smaller stake in the venture is so contrary to the one-share, one-vote rule, which is the basic decision-making rule of corporations, there is an argument for having a security for expenses statute in this context regardless of whether the English rule or the American rule is a desirable rule in other contexts. So, therefore, while you are right that the question of the English or the American rule raises an issue that is larger than the derivative suit context, I think it is wrong to suggest that there is no relationship between the ability of somebody with one share to sue and the particular kinds of constraints that you might want to place on that individual, even if you don't place constraints on other individuals in other types of lawsuits in the economy.

3. *Demand and Termination*

SCHWARTZ: On demand, the law for suits that are brought in federal court and the law that applies to suits that are brought in almost every other court as well requires that before the suit can begin, the plaintiff has to plead that he made a demand on the directors that the suit be brought or to explain that he didn't make a demand because to make such a demand would have been a futility. For example, if a board consisted of five people, all of whom are engaged in the same self-dealing transaction with the corporation, it's a waste of time to ask them to have the corporation bring suit against themselves. About two states also provide that demand must be made on shareholders.

The demand on directors used to be regarded as a fairly formalistic thing. A lot of people didn't want to bring the demand because they wanted to file in a real hurry before twenty other people filed the same lawsuit. There were certain economic advantages to the lawyer who was the first in the court room. But if you didn't make a demand when you should have, the court would send you back to make a demand, and there wouldn't be a whole lot lost.

The demand requirement now has very special significance because what will often happen is that after the suit is filed the board of directors will form a special litigation committee, hopefully to consist of three people who are not parties to the lawsuit. Indeed, if they are lucky, they are three persons who have joined the board of directors since the transaction in question, so that they can't be tainted in any way with having been interested in the transaction. The special committee may appoint outside counsel, may conduct some kind of investigation, may take some evidence, and will come up with a report. If the report recommends that the suit be terminated, then the corporation or the defendants will move to dismiss the lawsuit on grounds that the board has acted to terminate the lawsuit.

In New York, in a case called *Auerbach v. Bennett*,[9] the court said there were only two things they would inquire into: Was the committee independent? Did it function in an independent manner? If the answer to both of those questions was yes, the court says there is no further interest in this on the part of the court. The committee has acted to protect the interest of the corporation; the suit is terminated.

Delaware, in a case called *Zapata v. Maldonado*[10] said, in a case in which plaintiff didn't have to make a demand because of the futility of making the demand, the court would not necessarily accept the view of the committee as final; the court would exercise its discretion to examine the substance of the decision and indeed might allow discovery on the part of the plaintiff to prove that it was not in the interest of the corporation to terminate the lawsuit. If, on the other hand, the suit was one in which demand was required, the board's judgment is final if it met the standards of the business judgment rule, which meant the court basically wouldn't second guess

9 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

10 Zapata Corp.v. Maldonado, 430 A.2d 779 (Del. 1981).

what the committee did. The issue under Delaware law therefore comes down, to a large extent, on the question of whether demand is required. There has been a lot of law that has developed in the last couple of years under Delaware law as to when demand is required and when it is futile. But this is, indeed, a serious constraint on the ability of plaintiffs to conduct derivative suits.

I think that the law should move toward depriving defendants of the ability to decide whether the case against them should proceed. I think that Delaware made an essentially sound decision in *Zapata v. Maldonado* which gave the courts the opportunity to review the decision of the special litigation committee and, of considerable importance, allowed for discovery on the plaintiff's part so that they could find out if there was more there than they were aware of from the documents that were filed. That's been undercut by the *Aronson*[11] case, which imposed, I think, an unreasonable standard in connection with when demand would be required. It was a suit against a forty-seven percent shareholder of the company for self-dealing, and the court said that demand was not rendered futile by the fact that it was a suit against what would seem to be the controlling person of the company.

FISCHEL: Instead of hearing what judges think about whether procedures are fair, I want to know whether the large shareholders think the procedures are fair. They are the people who are really going to get the benefit or bear the costs of the procedures. Information costs are positive, and therefore it might not be cost efficient to prepare this report. It's very interesting to know what the institutional investors think.

MANNE: These are extraordinarily expensive forms of litigation. The litigation cost is on average double what the same ultimate result would cost in any other context because, in effect, the judge has to try the matter twice. He has to decide first whether there's a higher likelihood that he's going to find for the plaintiff in the case. If so, then you have a case to litigate. Indeed, I'll bet in some cases the first finding is more complicated than the second.

RIBSTEIN: I wanted to qualify a little bit of what Don said. I don't think, under my reading of current Delaware cases, that the demand on directors is all that significant for a number of reasons. In the first place, there are a couple of recent Chancery Court decisions that say that even where the plaintiff made a demand and was refused, and this is consistent with the langnage of *Zapata*, the court

11 Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

will still look at whether demand was required. In other words, whether the plaintiff made a demand in the first place isn't the significant point; the question is whether demand was required. It's true that the *Aronson* test makes it more difficult to sue when it is a demand-required situation. However, the way *Aronson*'s been interpreted, you just have to add more allegations. The court is going to look only at the allegations, rather than beyond the pleadings. Finally, there is some indication in the recent *Kaplan*[12] case that even in a situation where demand is not required, the court is not going to exercise independent business judgment except in egregious cases. This was predicted by some people at the time of *Zapata*. The bottom line is that I don't think the demand on directors is all that important right now.

C. Assessment of Litigation Costs

MANNE: Plaintiff's attorney is paid out of what would otherwise go to the corporation. On the other hand, we don't have any rule that penalizes the attorney in case the suit is lost. It may be worth looking into the question of whether some penalties would be appropriate, such as the rule in federal courts allowing judges to levy penalties on lawyers in cases where they find there is a frivolous prosecution or, more generally, the English rule on assessment of costs against the losing party.

GOETZ: In the normal situation of contingency fee cases, at least the putative beneficiary has a positive expected value from the case. In this situation, some small subset—as small as one—has a positive expected value, but the majority may not. Therefore, my conclusion is that I am generally sympathetic toward changing to the English rule if we possibly could.

The English rule avoids another problem with respect to the remedies we now have for abuse of process or bringing a frivolous claim. I wanted to put on my economist hat and tell all of you lawyers that I am not at all sure what, in the formal sense, an abusive or frivolous claim is. It does not seem to me that it is a claim, for instance, that only has a one percent chance of winning. There are lots of instances in which such a claim is socially beneficial if it's brought. Therefore, I'm not sure what it does mean, but it puts an enormous burden upon a court to separate frivolous claims and abuse of process from other kinds of claims.

LEUBSDORF: Henry's reference to the English rule suggests that it

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12 Kaplan v. Wyatt, 484 A. 2d 501 (Del. Ch. 1984), *aff'd*, FED. SEC. L. REP. (CCH) ¶ 92,345 (Oct 9, 1985).

should be imported to our legal system. I disagree. If these suits are to be brought at all, obviously no individual shareholder has the interest to bring them because he will get only a small slice of the recovery. Therefore, you have to collect in some way from all those who are benefited or from the corporation. I don't see how you can then say that if the plaintiff loses, he, or more likely his lawyer, has to pay the whole cost of the defense. The message you then send to the plaintiff's lawyer is that she should never take any of these cases unless there is a very, very high probability of winning or, alternatively, the expected fee is so huge that it dwarfs the possibility of having to pay the other side's fees.

D. Settlement

LEUBSDORF: I think one has to regard the provisions requiring delay of negotiation of attorneys' fees provisions until after the settlement has been approved by the court as a way of dealing, among other problems, with the special problem in this area that Professor Coffee has explored: There is interest on both sides in pushing the costs off onto the corporation itself. In a way the proposed rule is, in the short run, bad, perhaps for corporations, and certainly for defendants. Once the suit has been brought, obviously it's to your advantage to settle it as soon as possible, particularly if you are the defendant. On the other hand, in the long run, it may be to your benefit as a potential defendant that you will not be able to buy off the plaintiff as easily as was done before. This measure does have some impact at least in avoiding the situation where a weak suit is brought simply so the plaintiff's attorney's fees will get paid off.

CARNEY: This is not dissimilar from the greenmail problem which, in a sense, is kind of an extortion problem for managers. One solution that's being developed is a contract solution: Amend the articles or the bylaws of the corporation to prohibit greenmail, and announce that the officers of the company lack the power and ability to pay that kind of greenmail. I don't see anybody writing that kind of contract concerning derivative suit settlement into a corporate charter, which leads me to believe that we are not really talking about a very serious problem here.

LEUBSDORF: There are various possibilities. You might reinvigorate the corporation itself as an objector. You might have the court appoint someone. Maybe the Business Roundtable should constitute itself the guardian of the fee standards as I believe they did in the

Fine Paper litigation.[13] The approach of the proposed guidelines, I think, goes partway in that direction by saying no negotiation on fees can occur before the settlement is approved by the court.

Bill said, if preventing collusive settlements is a good proposal, why is it not written into corporate bylaws? There's probably no complete answer, but one thing, at least, occurs to me, and that is that the people who settle are the officers, so they would be the ones who would have to enter into contracts never to settle any derivative suits against themselves. Now you could, of course, write into the corporate bylaws a provision that indemnity would never be available to someone who settled the case, and that would certainly deal with that problem. On the other hand, if you think there is a need for a derivative suit in the first place, I think you would have some skepticism that the directors would get together and write a corporate bylaw that says we will never indemnify ourselves, unless we actually go to trial and win.

SCHWARTZ: Bill, I think that the reason no corporation through its officers and directors would adopt a provision like the one you are suggesting, a rule that would say that no derivative suit may be settled, that they all must be litigated, is that the officers and directors wouldn't dare do that for fear that under state law they could not get indemnification if they went to trial and they lost. State law right now prohibits them from being indemnified. You could change state law, but that would have to be a necessary complement to your suggestion.

CARNEY: Part of the response to Don's comments is that the provisions authorizing liability insurance coverage are broader than those for indemnification in a number of respects. You don't preclude entirely protecting managers, even when they lose on the merits of litigation, if you've got liability insurance. The other part of the answer, it seems to me, is that managers still have incentives to reduce the firm's cost. One form of those costs is extortion costs, if that's what we're talking about here, in terms of frivolous derivative actions. If this were a serious problem, it seems to me that managers would do that to reduce the cost of capital to the firm.

SCHWARTZ: Not when it's out of their pocket. That's the problem.

MANNE: They can't know that ex ante.

SCHWARTZ: No. Well, there is still a personal risk that they will be

13 In Re Fine Paper Anti-Trust Litigation, 98 F.R.D. 48 (E.D. Pa. 1983), *aff'd in part*, 751 F.2d 562 (3d Cir. 1984).

found liable. Indeed, there's a risk that you would be found liable even when you haven't done anything wrong. Managers therefore would not want to foreclose as a firm rule the opportunity to settle litigation for which they would stand a greater likelihood of being both insured and indemnified.

CARNEY: Even to the extent that the corporation is precluded from buying certain kinds of insurance, the manager is not. If you think of yourself as an honest person, you are not much worried about these moral hazards insurers won't deal with, which are mostly fraud and self-dealing problems.

SCHWARTZ: Even if they can buy their own insurance policy, it's very costly.

CARNEY: But it's not costly if that's a cost of hiring managers for the firm. It will be incorporated into their other compensation.

VI
RELATED AREAS

A. Closely-Held Corporations

MANNE: Many of these problems take on a different hue and probably involve different values as Harold Demsetz's work would certainly suggest, when we're talking about close corporations. There are two aspects to that. One is that the substantive approach might vary. The other is the question of whether there should be more statutory enabling provisions in one type of corporation than in the other. Would anyone care to make comments on the difference between the typical publicly-held corporation case that we've been talking about and one with, say, three, four, or five shareholders?

TULLOCK: I'll simply repeat what you have always said. They should have, and in practice do have, a different corporation law. They should permit all sorts of special litigation.

MANNE: How much difference in fact is there in the case law on derivative suits?

RIBSTEIN: I believe there are cases supporting a different treatment, in terms of permitting shareholders in close corporations to make an end run around the board more readily, among other things, because they have a more real interest involved.

MANNE: Certainly, you are not dealing with the same level of collective goods, free riders, etc. problems in close corporations. But where does that lead us? I presume towards allowing the suits to be brought more readily.

DOOLEY: With respect to the closely-held corporation, the major problem is illiquidity. John and I have found that the majority of litigation in the close corporation area is likely to be in connection with suits for involuntary dissolution, where the minority is simply trying to get out.

SCHWARTZ: The most difficult situation develops sometimes in a second generation of what started as a family business, or a two family business, and you've got one dominant family perhaps owning slightly more stock than the other where one family is deriving an income from the business and now has opportunities to deal unfairly with the minority shareholders. Or maybe the majority will deprive the minority of employment in the company, and then they have no place to go. Either they don't have a buyout agreement or they don't have one that covers every conceivable contingency. Maybe that was a conscious choice for good reason. They are kind of stuck with the situation. Maybe the majority is paying themselves excessive salaries, self-dealing, the kinds of things which in a public corporation would clearly be the basis of a derivative suit leading to corporate recovery. But corporate recovery seems strangely out of place in this situation. It's the individual recovery that is appropriate. There is a host of remedies that are appropriate in the close corporation situation that would not be appropriate in the public company situation: Dissolution of the corporation at one extreme, buying out the stock at some value to be determined because the value of the stock isn't self evident in those cases, perhaps injunction, perhaps damages. But the award probably ought to go to the minority shareholder directly at this point rather than to the corporation. There are even a few cases in public corporations where corporate recovery in a case where there was injury to the corporation has nonetheless gone to the individual shareholders rather than to the corporation itself. *Perlman v. Feldman*[14] is a leading case in this area where the recovery that the court decided was appropriate was given directly to the individual shareholders in order to avoid a windfall gain to the wrongdoers who owned about thirty-five percent of the stock of the company.

WOLFSON: The small shareholder's ability to contract in a close corporation is far greater than in a publicly-held corporation.

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14 219 F.2d 173 (2d Cir. 1955).

RIBSTEIN: With respect to whether we need fiduciary duties in close corporations in light of the fact that shareholders can contract, you have the problem of anticipating problems over time. The kind of agreement that Nick was referring to would be made at the outset of the corporation. It's very difficult to project a few years down the line what kinds of problems are going to arise. Maybe you do need the kind of implied contract that fiduciary duties provide.

CARNEY: With respect to Nick Wolfson's comment that it is easier to contract in close corporations, I used to believe that, but I'm less convinced that it's true now.

In close corporations the minority protects itself from overreaching through various sets of super-majority voting rules, class voting on various transactions, a whole variety of things, to constrain the majority. We are beginning to see some of those same devices in public corporations in shark repellents that are designed to limit the power of the dominant stockholder who comes in during a takeover, voting rules for takeout transactions being the most obvious. Beyond that, fair price requirements contain a whole set of prohibitions against self-dealing.

GOETZ: Endorsing in a kind of general way the distinction that we are making here between the closely-held and the dispersed ownership corporation, I want to express my nervousness about it. It's similar in lots of ways to the distinction between the so-called large numbers case and the small numbers case in public goods theory and between concentrated and decentralized industries. The operative question about which I am very nervous is how small do the numbers have to be and how closely-held does the corporation have to be to make a real difference? If this were a cartel, or a public goods problem, we would say that even so few as four or five or six people exercising common ownership rights creates a substantial number of questions. Indeed, I often argue to my students that between two and three you get a difference of kind rather than degree. After that, it's mostly degree. I have this kind of nervousness about closely held corporations as well.

DEMSETZ: I'm not sure exactly how you would define a closely-held corporation. There are two aspects in which there is a problem. Obviously there's going to be some kind of quantitative continuous variable that deals with the fraction of shares that's owned by a few shareholders. One problem is where to draw the line. More interesting than this is that a corporation that you would call a publicly-held corporation can, for a period of time, satisfy the quantitative definition of a closely-held corporation, as when a takeover takes place. When a takeover takes place, one person gathers in a great fraction of the shares. Does this company then qualify, for that period of time, for a separate body of legal doctrine? Even in some very large corporations, a dominant shareholder has fifty-percent of the stock in a few cases. Why should we let the minority shareholder bring a suit if we wouldn't in a closely-held corporation?

CARNEY: Offhand, I can see very little reason to treat it differently from a close corporation. At that point there are no duty of care cases to worry about. Where you have a dominant stockholder with a major block of shares, it's too large an interest to let serious negligence occur. Duty of loyalty cases are not cases of the manager stealing as much as they are disputes among co-investors about the terms of a transaction that's likely to take place—takeout mergers and that sort of thing. It seems to me that it's really a class action if there's any kind of an action at all among shareholders.

FISCHEL: Even if you can identify differences between the two entities, I think the problems are exactly the same, in the sense that the use of liability rules in litigation as a monitoring device is simply one of many monitoring devices, including explicit contract and the precise role of one versus the others. It's fine to say you can't anticipate every contingency. But that doesn't mean that a court is going to come in all-knowingly when a contingency comes up and reach the right answer. That's the problem with liberal fiduciary duties. It's true, you can tell the story about illiquidity and exploitation, you can use that as justification for liberal fiduciary duties or easy dissolution. The problem is the costs of making it easy to sue. You still have problems of strategic behavior. The rule of strict fiduciary duty makes it hard to pay people different things, even though their marginal contribution to the firm might be extremely different. That encourages people to free ride on the efforts of others and demand equal compensation. Easy dissolution has other types of problems in terms of forcing firms to be sold to some of the current investors or somebody else. So I don't think a priori you can say whether liability rules are more important or less important in close corporations.

ALCHIAN: Let me suggest a reason for the difference. A close corporation is one in which you do care who the other members are. You find that problem occurring whether it be a large number or small number.

There's a teamwork here, whether it be small or large, and that's what you are worried about. Examples are country clubs, where you don't let the guy just sell out, but make him sell back to the company and then they sell to somebody else of their choice. For that kind of enterprise, would you want different sets of rules about liability? In my conjecture, you might.

WOLFSON: There's another aspect to the close corporation which was observed some years ago. The problem is when the parties fall out in these deals, it becomes so much more difficult to meaningfully enforce the agreements they've worked out. People who worked together can no longer work together, even though that was their agreement. So you really want easy dissolution and dollars rather than specific enforcement of the agreement.

CARNEY: It seems to me that one significant difference is that in a public corporation, we've got investors with rational expectations, we've got market pressures to write the correct kinds of contracts, to reduce agency costs, and perhaps to reduce conflict among co-investors. You reach a level where the market no longer imposes that kind of constraint on the organizers of the firm. You are also talking about a different level of scale problems in writing an elaborate contract. There are economics of the large corporation with lots of investors that don't exist when you have the three person corporation trying to write the contract to anticipate an equal number of contingencies. So you've got scale problems, you've got bounded rationality problems and lack of a market to set the bounds of the contract. Maybe that's the functional way to look at what is a close corporation and what is a public corporation. It's very different from the way lawyers tend to look at it.

B. Direct Class and Injunction Actions

SCHWARTZ: Shareholder litigation sometimes takes the form of class action and not derivative suits. Some of the corporate law rules that tilt against the effective use of derivative suits don't operate at all when it comes to class actions, so that the special litigation committee, for example, is a device unknown to preventing class actions from proceeding. There are some very important cases in the corporate law area that are class actions. One that comes up for discussion and is even mentioned in the Fischel-Bradley paper is *Smith v. Van Gorkom*,[15] a recent Delaware case in which the business judgment rule was rejected in application to a particular merger. The case is asserted as a class action, and no special litigation committee could have operated to prevent it.

LEFTWICH: I'd like to confess my ignorance in asking a clarifying

[15] 488 A.2d 858 (Del. 1985).

question. Why is it when somebody wants to bring a suit they choose a derivative suit rather than a class action suit?

SCHWARTZ: There are some types of claims that can only be brought as derivative suits and some that can only be brought as class actions. The search is to see who the injured party is. Let's take one self-dealing transaction, excess compensation. That suit claims that the corporation wasted assets, that it paid too much. Therefore, the injured party directly is the corporation. Indirectly, investors may have suffered injury because the value of their stock was diminished, but that suit may only be brought as a derivative suit. By contrast, let's assume that the suit alleges that the managers refused to pay dividends when they should have paid dividends. The injury is directly to the individual shareholder. That suit may be brought as a direct action. The ultimate question in most of these cases is to seek to whom the recovery would go. If the recovery would go to the corporation, the suit must be asserted as a derivative action. If the recovery would go to the individuals, then it may be brought as a direct action.

FISCHEL: I just wanted to say that we focused on derivative suits because much of the commentary in corporate law focused on derivative suits, but there is nothing unique in our paper to derivative suits. Most of the concepts would apply equally well to class actions.

RIBSTEIN: Don Schwartz's summary of the law I think was somewhat of an oversimplification or at least gave some form where maybe there isn't. There is a recent case, for instance, *Moran v. Household International, Inc.*,[16] in which the court characterized as a derivative suit something that I think there would be a great deal of agreement was really a direct action. I think that the distinction should probably be made along policy lines. In other words, what are the problems that affect derivative suits that don't affect direct suits? Dan Fischel said a while ago that a lot of what he had to say affected both, in which case maybe if we're talking about prescribing rules here, we're talking about going across the board. I happen to think that the distinctions rise to a sufficient level of importance that there ought to be a difference in treatment.

MANNE: Is there a different rule for compensating attorneys in direct and derivative suits?

SCOTT: They still talk lodestar, they still pay attention to size of

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[16] 490 A.2d 1059 (Del. Ch.), *aff'd*, No. 37, 1985, slip op. (Del. Nov. 19, 1985).

recovery, and they're still conceptually confused about exactly what they are up to.

DOOLEY: Can you end up with no monetary recovery and the payment of attorney's fees?

SCOTT: That also can happen in the class action. You can bring a class action for injunctive relief.

DOOLEY: You can't get your attorney's fees except under a statute, Ken.

LEUBSDORF: You can under some circumstances, the leading case being *Hall v. Cole*,[17] a suit to require the restoration of democratic procedures in a union. The doctrine is the same one as in the *Mills* case, the common benefit case. In *Hall* the union members are thought to benefit and they will wind up paying the fee assessed against the union because they pay union dues. If you brought a suit for injunctive relief and you could not as in *Hall* pass the costs on to those who benefit, then you wouldn't be able to recover attorney's fees unless there was a statute. Actually, that is one of the areas where attorney's fee statutes have been passed most prolifically. For instance, in civil rights suits for injunctive relief or damages, it is the defendant who pays and not a third party or the plaintiff.

CARNEY: In derivative actions that are not for damages but for injunctive relief we are moving from rnles of liability to property rnles. This has always troubled me considerably. When we start talking about injunctive relief, we are talking about stopping a transaction some regular corporate procedure has approved, whether it's a shareholder vote or a director vote or simply a routine action of an officer who has the regular power to do certain things. In the context of corporate mergers, for example, one minority shareholder says it's unfair to me after a transaction has taken place.

FISCHEL: It's not that he doesn't like the deal. They are not willing to give back the premium. They want to keep the premium and get more. It's a costless option. Nobody's saying, "I want to undo this." It's "give back the premium."

CARNEY: Injunction suits are simply the holdout case where the holdout stockholder is trying to impose a rule of unanimous consent on the corporate body, for which I find no justification at all.

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17 412 U.S. 1 (1973).

C. Duties to Bondholders

BRADLEY: When you look at bondholder covenants, what you'll find is that although they are explicit, they, too, are limited in what they constrain and what they monitor. For example, there are no covenants that say you should take on all positive net present value projects or reject all negatives, but rather it has to do with observables. There's never a bond covenant that says you can't pay dividends, but rather you can pay dividends out of a pool of funds, and things like that.

RIBSTEIN: Maybe the difference between the shareholder contract and the bondholder contract is explained by the fact that the shareholders don't care about these specific duties. All they care about is that they're getting a decent return.

FISCHEL: I think that there is something of a conceptual confusion there. If stealing could be reduced at a cost of zero, then there's no rational explanation of why equity holders, regardless of what their expected rate of return was, wouldn't want to do it. I think the problem, in both the debt holder and the equity holder cases, but in different ways, is that it is impossible, beyond a certain point, to reduce the cost of stealing without creating even greater costs by the prevention measures that you are undertaking. A contract which attempted to minimize self-dealing by precluding wide categories of director action would probably reduce the level of self-dealing, but the amount of beneficial conduct you would wipe out at the same time would make it an inefficient contract to write, which is why you don't observe it. I don't think it's so much a matter that people don't care about stealing, it's just they'll only try to prevent it up to the point of where the costs of prevention are less than the expected benefits from the reduced self-dealing.

SCHWARTZ: The bondholder engages in a true bargaining situation through the underwriter who markets these bonds, because the underwriter puts himself in the position of his customers who will purchase these bonds and will negotiate the terms of the trust indenture in an actual, hard contested bargaining situation. The bondholder is indifferent to stealing and to shirking for several reasons. Shirking affects the shareholders. Stealing, for the most part, will affect the shareholders. So long as the bondholder is paid his interest and principal when due, he doesn't care whether the company maximizes profits or not. And, he has a much more effective remedy than the shareholder does, if, for one reason or another, the interest isn't paid, which is that he can foreclose on the bond. If he has collateral, he can protect himself through the collateral. If he doesn't have collateral he can, perhaps, cause the company to go into bankruptcy by making the entire bond due immediately. That's a far more effective remedy than anything that the shareholder has for stealing or for the effects of shirking.

ALCHIAN: I wish you were right, Don, but you're not. It isn't true that when the equity or the stock price of firms goes down the bondholders aren't affected too. It's true that the bondholder has the first claim, but the size of the residual is not irrelevant.

DOOLEY: The reason you see this kind of contracting on behalf of bondholders and not shareholders is that, in some sense, bondholders face a higher risk. That sense is as follows: Management has an interest in working in the best interest of the shareholders, but not the bondholders, once the money is borrowed. That does not indicate that this kind of financial covenanting is not costly—indeed, it demonstrates that it is costly, and this is one of the ways in which bondholders try to reduce the risk to which they would otherwise be subject. Otherwise, as soon as the loan was made, management has an incentive to put off as much uncompensated risk on the bondholders as possible.

GOETZ: People who are attempting to write these opting out contracts rely on broad duties on the one hand and, on the other, try to articulate in detail exactly what it is they want the trustees or the directors to do. You have a lot of illustrations in these kinds of relationships of reliance being placed upon a broad and somewhat ephemeral duty of care, duty to use best efforts or whatever. Dan and Mike referred to these types of problems in regard to describing the alternatives in their paper. If you begin to lay out in detail exactly what you want the trustee or the director to do for you, you'd better do a darn good job of it. Otherwise you get into the difficulties of courts not knowing whether you are simply articulating some of the things that come within the purview of the broad duty or whether you are cutting back on the broad duty. Bob Scott and I describe this in a recent contracts article[18] as the difficulty of the court knowing whether the detailed specifications are "trumps" of the original relationship, which actually change it, or whether they are "supplements" where the parties simply spin out in more detail what they want.

DEMSETZ: There is a fundamental problem in a very detailed specification of obligations. The more detailed specifications are, the

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18 Goetz and Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985).

more the specifier is actually doing the managing. If you hire somebody to do the managing, you have to leave him with a significant degree of freedom. That's what the art of managing requires. So even if it were technically possible, you wouldn't want to specify everything in detail. You might as well not hire the manager to begin with.